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Malcolm F. McPherson

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For information contact:
CAER II Project Office
Harvard Institute for International Development
14 Story Street
Cambridge, MA 02138 USA
Tel: (617) 495-9776; Fax: (617) 496-9951
Email: caer@hiid.harvard.edu

Promoting Financial Development in Southern Africa: The Roles of Botswana and Mauritius

Malcolm F. McPherson*

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Malcolm F. McPherson is a fellow of the Harvard Institute for International Development. He is currently senior advisor on the Equity and Growth through Economic Research (EAGER) Project and principal investigator for the study "Restarting and Sustaining Growth and Development in Africa." He holds a Ph.D. in economics from Harvard University.

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List of Abbreviations

BIDPA	Botswana Institute of Development Policy Analysis
BIS	Bank for International Settlements
BOIB	Botswana Institute of Bankers
BoM	Bank of Mauritius
CAER	Consulting Assistance on Economic Reform
CBG	Central Bank of the Gambia
CEE	Centre d'Etudes Economiques
EPZ	Export Processing Zone
GDI	Gross Domestic Investment
GDP	Gross Domestic Product
GDS	Gross Domestic Savings
GoB	Government of Botswana
GoM	Government of Mauritius
HIID	Harvard Institute for International Development
IFC	International Finance Corporation
IMF	International Monetary Fund
MADIO	European Union–supported statistics project in Madagascar
MoF	Ministry of Finance
NBFI	Non-Bank Financial Intermediaries
RSA	Republic of South Africa
SADC	Southern Africa Development Community
SBM	State Bank of Mauritius
SOE	State-Owned Enterprise
UCB	Union Commercial de Banque

Executive Summary

This study considers the roles that Botswana and Mauritius might play in promoting financial development throughout Southern Africa. Both countries plan to become international financial service centers. Mauritius is well advanced in this effort. It began the process in the late 1980s and has progressed by drawing on opportunities in the Indian Ocean basin. Botswana announced that it would create such a center several years ago. It has only just finalized the legislation needed to support the initiative.

The two countries have followed different strategies. During the initial stages, the Government of Botswana sought to create a low-tax, convenient location in which financial enterprises in South Africa can base their operations throughout Southern Africa. The idea was to establish activities unrelated to diamond mining that will be an additional source of value-added and employment.

By contrast, Mauritius views the expansion of financial services as the “fourth pillar” of a broad strategy to sustain rapid economic growth well into the next century. The Government of Mauritius sees a major opportunity for its financial enterprises (and others it might attract) to use the growing power of information technology to take advantage of Mauritius’ location that straddles time zones in Europe and Asia.

Will these strategies succeed? What is required for them to succeed? Will the financial services spill over in ways that stimulate financial development throughout Southern Africa? Since Botswana is only in the early stages of establishing an international financial services center, South African financial enterprises will need some time to determine if there is significant advantage operating out of Botswana. For Mauritius, which already has well-established international financial links (notably through the Offshore Banking Sector), success will be seen in terms of the rapid expansion of information-intensive financial services.

There are a number of requirements for success. These include continued macroeconomic stability in both Botswana and Mauritius. Botswana’s strategy will be boosted, especially over the short and medium term, by the slow rate of economic and financial reform in South Africa. In the case of Mauritius, its entrepreneurs will need to continue making inroads in Madagascar, Mozambique, Tanzania, and Namibia. Continuation of the tax treaty that enables Indian residents to funnel resources through Mauritius to India will help as well.

Finally, the activities now underway in Botswana and Mauritius will stimulate financial development throughout Southern Africa to the extent that countries in the region implement and sustain economic reform. The greatest drag on financial development throughout Southern Africa remains the economic disruption due to the general unwillingness of most governments to sustain economic reform. Botswana and Mauritius have shown that rapid growth in Southern Africa is not only possible but can be sustained. That growth has been accompanied by comprehensive financial development.

1. Introduction

This report examines the potential role of Mauritius and Botswana in promoting financial development throughout Southern Africa. Our focus is Madagascar, to which Mauritius has strong financial links, and the members of the Southern Africa Development Community (SADC).[1] For reasons given in the next section, the study does not cover South Africa even though it is now a member of SADC. A prominent subtheme of the report, however, is how Mauritius and Botswana can help promote financial development in a subregion that includes one economy (South Africa) with a highly sophisticated (though fragmented) financial system.

The governments of Mauritius and Botswana have taken steps to create international financial service sectors. The initiative began in Mauritius in the late 1980s with legislation to support an offshore banking sector. The Government of Botswana (GoB) announced in the early 1990s that it would establish an international financial services center. It has taken until 1999 for the necessary legislation to be formulated and passed.

Both Botswana and Mauritius have made some progress towards realizing their ambitions. Based on historical evidence of financial development (for which an exceedingly rich literature exists)[2] their chances of success are high. There is room for the expansion of financial services throughout Southern Africa. The sheer scale of international financial markets implies that there will be few external limits on the capacity of financial services to expand within Southern Africa. Whatever limits there are will result from trends in income, wealth, governance, and confidence within Southern Africa itself.

Historical experience shows that most economies have developed financially because their organizations and entrepreneurs take advantage of *local* access and knowledge in ways that create and build upon *local* financial "niches." This is already happening in Botswana and Mauritius. What the present report explores is how the changes now underway in Botswana and Mauritius can stimulate broader financial development throughout Southern Africa.

The report is organized as follows. Section 2 explains our focus on Mauritius and Botswana and presents data on the economy of Southern Africa. Section 3 examines financial development in Mauritius and considers that country's financial strengths and weaknesses. Section 4 does the same for Botswana. Section 5 considers some challenges to the promotion of financial development in Southern Africa. Section 6 discusses how Botswana and Mauritius can help meet those challenges. Section 7 contains concluding comments.

Four annexes provide supplementary material. Annex A, coauthored by Clive Gray and Pepe Andrianomanana, provides details of financial development in Madagascar. Annex B uses data from Botswana and Mauritius to test the hypothesis advanced by Ronald McKinnon that, in fragmented financial systems, real money balances and real investment are complementary. Annex C has a note on the difference between finance capital and real resources. Confusion between the two has been a major source of financial disruption in Southern Africa (and elsewhere). Annex D provides notes on central bank independence.

2. Background: Financial Development in Southern Africa

a. Why Botswana and Mauritius?

An equally applicable question could be why will South Africa not be taking the lead in promoting financial development in Southern Africa, at least over the medium term? This question may appear paradoxical given the depth and sophistication of South Africa's financial markets and financial enterprises. Johannesburg is a world-class financial center with many well developed institutions—a stock exchange, commercial and merchant banks, brokerage firms, leasing houses, and insurance companies. The Reserve Bank of South Africa, which began operations in 1921, has a reputation for a conservative, rigorous approach to financial supervision and regulation and for its independent, solid financial advice.[3] Yet for all its potential, South Africa has not provided the leadership needed to promote financial development in Southern Africa. Its policymakers have shown that their priority is to strengthen South Africa's role within the broader system of trade and exchange beyond Southern Africa.[4] Furthermore, South Africa has also shown that it will not take financial measures that would benefit other countries in Southern Africa if such measures would aggravate its domestic problems of unemployment and inequality.[5] Indeed, in response to local pressures for continued trade protection, South Africa has been unwilling to liberalize its systems of trade, finance, and exchange in ways that would move the economy of Southern Africa forward.[6]

These comments do not mean that economic activity within South Africa or the actions of its enterprises and entrepreneurs beyond its borders will be irrelevant for financial development in Southern Africa. The basic point, however, is that financial changes within South Africa are unlikely to provide an important stimulus to financial development in Southern Africa for the foreseeable future.

This has both positive and negative implications for Botswana and Mauritius as they seek to expand their roles as financial service sectors. On the one hand, the less dynamic and aggressive that South Africa remains as a financial services sector within Southern Africa, the greater scope for expansion available throughout the region to enterprises based in Port Louis or Gaborone. On the other hand, the longer that South Africa delays reforming its economy, the longer it will take the whole of Southern Africa to grow and develop.

b. The Economy of Southern Africa—Some Data

The economy of Southern Africa is highly dualistic. South Africa itself is an example. The history of racial separation and the progressive tightening of international sanctions during the 1970s and 1980s produced a highly sophisticated, yet distorted, financial system whose main function was to sustain the expansion of mining, agriculture, and industry. The outcome was that South Africa's financial system (just like its economy) became highly segmented. The authorities in South Africa have been coming to grips with this problem. The more extreme distortions, such as exchange controls, have been selectively removed. Progress, however, has been halting and uneven.[7]

Trends in the aggregate data clearly show the need for financial development throughout the whole of Southern Africa. There are a number of indicators. The first is the lack of dynamism and growth throughout the region. Apart from Botswana and Mauritius, whose growth rates over the last three decades have been high even by world standards, most of the other countries in Southern Africa (including South Africa) have regressed. Zimbabwe is in a state of macroeconomic meltdown. So is Zambia.[8] Peace has been elusive in Angola, and when it comes, years of reconstruction lie ahead. The economy of Mozambique is recovering, but it lacks financial infrastructure and remains extremely dependent on foreign aid. Tanzania's financial system is being revived in the wake of the collapse of the main state-owned bank. Madagascar, as shown in Annex A, has taken some constructive measures to improve its financial system although its institutional base remains weak. The Democratic Republic of Congo (admitted as a member of SADC in September 1997) cannot develop in any meaningful sense until peace is restored. Even then, sustained economic growth is unlikely for many years. Finally, Lesotho, Swaziland, and Namibia which, like Botswana, belong to the Southern African Customs Union, are for all practical purposes fully integrated with South Africa and dependent upon its path of development.

These points are evident in the data in Tables 1 to 5. Table 1 contains several series that help us compare the principal macroeconomic and financial data for Mauritius, Botswana, and South Africa. Table 2 has data on the real exchange rate in these countries. Table 3 reports the growth of real gross domestic product (GDP) and the money/GDP ratio for other countries in Southern Africa. Table 4 has time series on the rate of inflation and the ratio of the budget deficit to GDP. Table 5 reports data on gross domestic investment and gross domestic savings (and implicitly the "resource balance").

These data point to major differences in economic performance. At the macroeconomic level, the region consists of economies that have performed well (Botswana and Mauritius) and the rest. When seen in a broader context, South Africa's economic performance has been poor.

This is clear from Table 1. Botswana and Mauritius have grown rapidly since the early 1970s. South Africa had periods of robust growth until the early 1980s but has done poorly since. In the six years since 1982, real GDP has actually fallen. In per capita terms, the differences in performance are striking. Indeed, in South Africa real per capita income in 1997 was no higher (in U.S. dollars and constant rand) than in 1969.[9] Reasons for these differences are evident from other data in the table. Rates of investment in both Botswana and Mauritius have risen over time and been sustained. The rate of investment in South Africa has fallen significantly below 20 percent of GDP, especially since the mid-1980s. The patterns of domestic investment in all three countries broadly reflect savings behavior although in the case of Botswana, savings have been so high (regularly exceeding 40 percent of GDP) that a large amount of its resources has been invested abroad. This was not the case in either Mauritius or South Africa. Based on estimates of the resource balance, Mauritius has been importing capital while South Africa, until recently, has had a neutral payments position.

Table 1. Selected Macroeconomic Indicators: Botswana, Mauritius and South Africa

Year	GDP at Market Prices (mill. USD)			GDP Growth			Gross Domestic Investment (percent of GDP)			Gross Domestic Savings (percent of GDP)		
	Botswana	Mauritius	South Africa	Botswana	Mauritius	South Africa	Botswana	Mauritius	South Africa	Botswana	Mauritius	South Africa
1970	89.2	221.1	17462.1	15.8	-0.4	6.3	39.6	9.9	30.4	11.3	11.2	26.8
1971	116.4	248.1	19248.6	18.3	4.3	4.9	44.7	14.5	28.9	22.8	10.1	24.7
1972	150.7	314.4	20208.7	32.2	8.3	0.2	49.2	15.3	23.7	35.5	17.5	26.4
1973	212.5	398.9	27693.2	21.9	12.0	6.0	46.8	24.9	27.7	35.2	22.8	30.5
1974	299.4	661.0	34864.9	20.8	8.8	8.2	48.5	25.2	33.4	35.8	31.1	32.8
1975	344.9	664.3	36032.0	-1.1	0.9	1.4	43.1	26.3	31.7	30.5	27.3	29.2
1976	384.1	704.0	34522.8	19.0	23.8	1.0	35.9	30.8	29.1	29.1	23.9	28.1
1977	433.7	823.7	38252.2	3.5	6.6	-1.6	26.4	30.0	22.4	21.2	19.3	28.0
1978	533.6	1015.4	43983.8	19.5	3.8	2.7	32.4	30.7	23.2	19.7	18.4	30.4
1979	730.2	1211.2	54359.8	9.9	3.5	3.6	32.7	31.2	23.0	28.9	19.5	32.8
1980	1035.4	1131.8	78743.8	14.3	-10.1	7.9	35.3	20.7	28.3	35.7	10.5	36.5
1981	1199.5	1142.3	80995.5	9.5	5.9	6.9	38.1	25.3	34.2	33.3	14.8	32.5
1982	1042.6	1078.4	74166.1	7.5	5.5	-1.6	40.9	18.2	29.4	26.5	15.4	29.3
1983	1130.1	1090.3	82090.5	16.0	0.4	-2.7	28.2	17.5	24.4	33.6	17.1	28.2
1984	1296.9	1040.6	72678.4	11.5	4.7	5.9	24.7	22.0	25.7	37.0	18.7	27.6
1985	1212.4	1076.2	55246.4	7.2	7.0	-2.7	28.5	23.5	19.9	39.4	21.6	29.0
1986	1350.3	1462.9	62692.8	7.5	9.7	0.4	15.2	21.9	18.2	45.4	28.6	27.5
1987	1646.3	1880.9	82070.5	8.9	8.9	2.9	23.0	25.6	17.9	44.4	27.6	25.9
1988	2398.3	2134.5	88168.3	15.3	6.8	3.7	26.7	31.0	20.2	67.1	26.1	25.7
1989	2932.2	2181.9	91753.1	13.1	4.5	2.4	29.0	31.1	20.5	49.9	23.8	25.8
1990	3386.9	2642.5	106681.6	5.6	7.2	-0.3	31.8	30.9	17.1	36.2	23.6	23.1
1991	3940.5	2831.3	112309.0	8.7	4.3	-1.0	31.6	28.7	16.1	37.8	24.9	21.1
1992	3966.1	3189.2	119850.3	6.3	6.2	-2.2	29.4	29.3	14.2	37.7	26.1	18.2
1993	4097.9	3195.4	116989.5	-0.1	5.4	1.3	27.9	30.7	14.5	32.9	24.5	18.5
1994	4316.5	3503.5	121443.5	4.1	4.1	2.7	25.5	32.3	17.0	38.7	23.4	18.8
1995	4584.7	3967.3	133612.9	3.1	4.7	3.4	28.2	25.7	18.9	39.1	23.2	19.1
1996	4936.2	4298.8	126237.9	7.0	5.4	3.2	25.8	25.1	17.4	41.9	23.9	18.7
1997	5069.7	4397.7	129093.6	6.9	5.0	1.7	25.9	27.6	15.9	44.7	24.1	17.0

Sources: World Development Indicators, 1999, World Bank * - International Financial Statistics, 1998, 1999, IMF

Table 1 (continued) Selected Macroeconomic Indicators: Botswana, Mauritius and South Africa

Year	Overall Budget Deficit including grants (percent of GDP)			Current Account Balance (percent of GDP)			External Debt (percent of GDP)			Exchange Rate (n.c. per USD, period average)		
	Botswana	Mauritius	South Africa	Botswana	Mauritius	South Africa	Botswana	Mauritius	South Africa	Botswana	Mauritius	South Africa
1970	..	..	..	..	..	..	19.5	14.3	0.0	0.71	5.56	0.71
1971	-13.5	..	..	..	..	..	28.5	13.4	0.0	0.72	5.49	0.72
1972	-19.0	..	-4.2	..	..	..	49.6	11.4	0.0	0.77	5.34	0.77
1973	-8.7	-1.2	-2.6	..	..	..	54.1	10.6	0.0	0.69	5.44	0.69
1974	-2.8	-5.4	-4.9	..	..	..	44.8	7.2	0.0	0.68	5.70	0.68
1975	0.5	-4.6	-5.4	-10.3	..	..	42.9	7.9	0.0	0.74	6.03	0.74
1976	-6.5	-4.4	-6.7	-5.3	-5.0	-5.5	44.0	9.2	0.0	0.87	6.68	0.87
1977	-1.2	-8.4	-6.2	-6.2	-9.5	1.6	44.3	17.3	0.0	0.84	6.61	0.87
1978	-1.6	-11.6	-5.5	-21.7	-11.5	3.6	25.2	24.7	0.0	0.83	6.16	0.87
1979	3.5	-11.5	-4.3	-8.3	-12.0	6.3	19.2	30.8	0.0	0.82	6.31	0.84
1980	-0.2	-10.3	-2.3	-14.6	-10.3	4.5	14.2	41.3	0.0	0.78	7.68	0.78
1981	-2.0	-12.7	-4.0	-25.3	-12.9	-5.5	14.0	47.6	0.0	0.84	8.94	0.88
1982	-2.1	-11.8	-3.8	-13.9	-3.8	-4.3	20.3	54.0	0.0	1.03	10.87	1.09
1983	8.4	-7.7	-5.2	-7.0	-1.8	0.0	20.7	51.5	0.0	1.10	11.71	1.11
1984	12.7	-4.5	-4.7	-4.5	-4.9	-2.2	20.9	52.8	0.0	1.30	13.80	1.48
1985	21.2	-3.5	-4.0	6.8	-2.7	4.7	29.0	58.4	0.0	1.90	15.44	2.23
1986	20.9	-1.8	-5.5	8.0	6.4	5.0	30.5	45.9	0.0	1.88	13.47	2.29
1987	16.8	0.2	-7.2	38.2	3.5	3.6	33.4	43.5	0.0	1.68	12.88	2.04
1988	19.5	0.3	-5.4	8.1	-2.6	1.4	22.5	40.9	0.0	1.83	13.44	2.27
1989	9.8	-1.4	-0.2	16.8	-4.7	1.7	18.9	38.8	0.0	2.01	15.25	2.62
1990	12.1	-0.4	-4.3	1.2	-4.5	1.9	16.6	37.3	0.0	1.86	14.86	2.59
1991	10.2	0.0	-4.3	8.6	-0.6	2.0	15.7	36.8	0.3	2.02	15.65	2.76
1992	10.7	-0.7	-9.5	6.2	0.0	1.5	15.4	32.9	0.5	2.11	15.56	2.85
1993	10.0	0.0	-10.2	12.3	-2.9	1.6	16.1	31.5	5.7	2.42	17.65	3.27
1994	1.9	-0.3	-6.3	5.5	-6.6	-0.3	16.0	39.5	17.8	2.68	17.96	3.55
1995	2.8	-1.2	-6.0	7.4	-0.6	-2.1	15.3	44.3	19.0	2.77	17.39	3.63
1996	9.4	-4.0	-5.8	12.3	0.7	-1.4	12.4	42.3	20.6	3.32	17.95	4.30
1997	..	-4.0	-3.8	14.2	-2.6	-1.5	11.1	56.2	19.5	3.65	20.56	4.61

Sources: World Development Indicators, 1999, World Bank * - International Financial Statistics, 1998, 1999, IMF

Table 1 (continued) Selected Macroeconomic Indicators: Botswana, Mauritius, and South Africa

Year	Inflation (CPI, period average)			Broad Money * (percent of GDP)			Net Foreign Assets * (percent of GDP)			Money Multiplier *		
	Botswana	Mauritius	South Africa	Botswana	Mauritius	South Africa	Botswana	Mauritius	South Africa	Botswana	Mauritius	South Africa
1970	..	1.7	4.5	14.7	44.0	62.5	..	26.8	5.5	..	3.2	9.4
1971	9.3	0.3	5.8	12.7	46.1	61.5	..	23.1	3.1	..	3.7	9.7
1972	0.6	5.4	6.5	11.5	47.3	64.0	..	28.1	6.1	..	3.1	10.6
1973	5.5	13.5	9.5	12.4	47.5	63.4	..	21.4	4.2	..	3.4	10.8
1974	11.3	29.1	11.8	11.4	49.3	60.0	..	23.9	2.9	..	3.3	10.9
1975	11.1	14.7	13.4	11.7	57.0	63.8	..	33.3	1.1	..	3.0	11.3
1976	11.7	13.0	11.1	28.6	50.8	61.4	21.6	15.1	-1.9	2.6	2.7	11.6
1977	13.2	9.2	11.2	31.1	43.2	61.2	23.7	5.3	-1.6	3.0	2.6	11.9
1978	9.0	8.5	10.3	29.4	45.7	61.8	30.3	1.7	3.7	3.4	2.7	12.4
1979	11.7	14.5	13.1	35.1	40.8	60.3	37.4	-3.9	8.7	3.5	3.0	12.6
1980	13.6	42.0	13.9	30.7	44.1	55.1	32.9	-1.2	9.3	3.8	3.3	9.3
1981	16.4	14.5	15.1	25.8	39.1	55.9	24.9	-12.5	3.3	4.3	3.3	9.5
1982	11.1	11.4	14.7	27.3	42.0	55.9	34.8	-11.4	2.3	2.6	3.7	12.2
1983	10.5	5.6	12.4	27.4	42.5	56.0	39.2	-16.2	1.3	3.0	3.8	12.2
1984	8.6	7.4	11.6	26.5	43.1	57.2	52.1	-14.3	-0.4	2.9	4.1	12.6
1985	8.1	6.7	16.2	30.5	49.0	57.1	90.8	-9.1	-2.2	3.5	4.6	13.0
1986	10.0	1.6	18.7	25.0	53.4	53.4	91.2	1.4	0.2	3.7	4.9	13.2
1987	9.8	0.5	16.1	36.1	56.4	54.7	112.5	13.4	2.2	3.6	5.0	13.4
1988	8.4	9.2	12.8	31.4	61.3	57.9	112.1	20.4	0.6	3.0	5.2	12.3
1989	11.6	12.7	14.7	30.8	60.9	58.1	89.7	24.9	0.1	3.3	5.0	11.6
1990	11.4	13.5	14.4	23.6	62.6	56.7	97.0	30.2	0.3	3.2	5.1	10.7
1991	11.8	7.0	15.3	29.3	67.6	59.0	104.5	34.0	0.6	4.0	2.7	10.2
1992	16.2	4.6	13.9	29.6	69.9	55.1	103.5	32.2	-3.1	5.5	3.4	10.5
1993	14.3	10.5	9.7	23.2	71.8	52.0	115.3	29.4	-4.3	5.0	4.3	12.1
1994	10.5	7.3	9.0	21.5	72.4	54.8	96.0	25.2	-4.8	5.7	5.2	12.2
1995	10.5	6.0	8.6	21.4	78.4	56.4	97.5	27.2	-3.7	6.2	5.4	10.9
1996	10.1	6.6	7.4	21.8	75.4	57.8	127.5	25.7	-5.7	7.0	5.1	11.0
1997	8.6	6.8	8.5	22.8	79.0	62.1	123.9	25.6	-3.9	7.2	7.4	11.6

Sources: World Development Indicators, 1999, World Bank   * - International Financial Statistics, 1998, 1999, IMF

One reason for the differences in domestic savings rates for the three countries is the markedly divergent experiences with respect to the budget deficit. Botswana has had a large budget surplus for more than a decade and a half.[10] The external-debt data reflect the slow working down of low-interest-rate loans provided by international agencies before Botswana's economic performance made it ineligible for such assistance. Mauritius has shifted from a period of large deficits to basic balance with some drift back to higher deficits over the last several years. These deficits have been reflected in a sharp increase in Mauritius' external debt. By contrast, South Africa has had an unbroken record of budget deficits stretching back at least three decades. While financial and other controls were in place in South Africa these deficits were financed through local captive markets consisting mainly of insurance companies, commercial banks, and state-owned enterprises. But with the progressive opening up of the economy the deficits are now effectively financed from abroad. This is evident from the current account deficit on the balance of payments and the rapid growth in foreign debt.

The data on exchange rates reflect general trends peculiar to each economy. With its large and growing international reserves, Botswana's exchange rate has been highly stable. Because of its dependence on exports, Mauritius' exchange rate has tended to fluctuate. By contrast, the exchange rate in South Africa has become increasingly volatile over recent years. Figure 1 (derived from data in Table 2) shows that the real exchange rate has been relatively stable in all three countries apart from a bump between 1983 and 1987 when the world economy as a whole experienced major realignments of key exchange rates. The trend in the real exchange rates for all three countries has been towards a modest depreciation.

Inflation rates in Botswana, Mauritius, and South Africa have been broadly similar. South Africa has had (and continues to have) chronically high inflation primarily from the rapid growth of domestic credit associated with deficit financing. Botswana, with its close trading links to South Africa through the Southern African Customs Union, has experienced similarly high rates of "imported inflation." By contrast, Mauritius has had a fluctuating rate of inflation that has responded to developments in world markets and periodic bouts of domestic monetary expansion.

The final three data panels in Table 1 provide information on the financial system. Both Mauritius and South Africa have high ratios of broad money to GDP characteristic of more highly developed financial systems. That ratio has been relatively low in Botswana. The principal money supply "formation factor" in Botswana has been the growth of net foreign assets. Their effect on the domestic money supply has been largely offset, or "sterilized" by the accumulation of government balances with the banking system. In Mauritius, a major stimulus to monetary growth has been the buildup of net foreign assets. However, these assets have not been sterilized. Finally, the data for South Africa suggest that the foreign sector has on balance reduced the local money supply. The dominant monetary formation factor in South Africa has been domestic credit creation. Figure 2 and the last panel of Table 1, showing the money multiplier, provide some idea of the underlying systemic changes in all three economies. For South Africa, the overall stability in the multiplier (with a range of 9.3 to 13.4 over 28 years) suggests that the basic financial relations determining the local money supply have varied little over time. The rise in the money multiplier in both Botswana and Mauritius (in both countries it more than doubled) point to a pattern of comprehensive financial change.

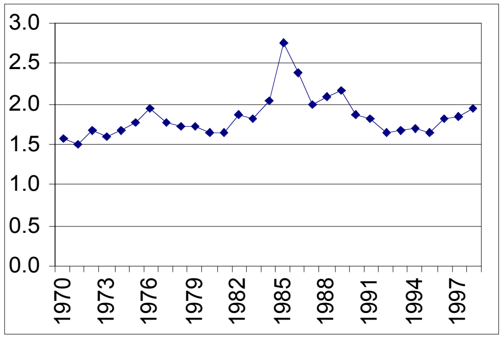
Table 2. Real Exchange Rates: Botswana, Mauritius, and South Africa

Year	Exchange Rate (n.c. per USD, period average)			CPI (1990=100)			WPI (1990=100)	Real Exchange Rate (n.c. per USD, period average)		
	Botswana	Mauritius	South Africa	Botswana	Mauritius	South Africa	USA	Botswana	Mauritius	South Africa
1970	0.71	5.56	0.71	14.3	11.76	9.3	31.7	1.58	14.98	2.43
1971	0.72	5.49	0.72	15.7	11.79	9.8	32.8	1.49	15.26	2.39
1972	0.77	5.34	0.77	15.8	12.43	10.5	34.2	1.66	14.69	2.50
1973	0.69	5.44	0.69	16.7	14.1	11.5	38.7	1.61	14.94	2.34
1974	0.68	5.70	0.68	18.7	18.21	12.8	46.0	1.67	14.41	2.44
1975	0.74	6.03	0.74	20.9	20.89	14.5	50.3	1.78	14.51	2.57
1976	0.87	6.68	0.87	23.4	23.6	16.2	52.6	1.95	14.89	2.82
1977	0.84	6.61	0.87	26.5	25.76	18.0	55.8	1.77	14.31	2.70
1978	0.83	6.16	0.87	28.9	27.96	19.8	60.2	1.73	13.27	2.64
1979	0.82	6.31	0.84	32.2	32.01	22.4	67.7	1.71	13.34	2.54
1980	0.78	7.68	0.78	36.6	45.45	25.5	77.3	1.64	13.07	2.36
1981	0.84	8.94	0.88	42.7	52.03	29.3	84.3	1.65	14.48	2.52
1982	1.03	10.87	1.09	47.4	57.96	33.7	86.0	1.87	16.13	2.77
1983	1.10	11.71	1.11	52.4	61.2	37.8	87.1	1.82	16.66	2.57
1984	1.30	13.80	1.48	56.9	65.73	42.2	89.2	2.04	18.73	3.12
1985	1.90	15.44	2.23	61.5	70.13	49.0	88.7	2.74	19.53	4.03
1986	1.88	13.47	2.29	67.6	71.27	58.2	86.2	2.40	16.29	3.38
1987	1.68	12.88	2.04	74.3	71.64	67.6	88.4	2.00	15.89	2.66
1988	1.83	13.44	2.27	80.5	78.21	76.2	92.0	2.09	15.81	2.74
1989	2.01	15.25	2.62	89.8	88.11	87.4	96.6	2.17	16.72	2.90
1990	1.86	14.86	2.59	100	100	100.0	100.0	1.86	14.86	2.59
1991	2.02	15.65	2.76	111.8	107	115.3	100.2	1.81	14.66	2.40
1992	2.11	15.56	2.85	129.8	111.97	131.3	100.8	1.64	14.01	2.19
1993	2.42	17.65	3.27	148.4	123.75	144.0	102.3	1.67	14.59	2.32
1994	2.68	17.96	3.55	164.1	132.81	157.0	103.6	1.69	14.01	2.34
1995	2.77	17.39	3.63	181.3	140.82	170.5	107.3	1.64	13.25	2.28
1996	3.32	17.95	4.30	199.6	150.04	183.2	109.8	1.83	13.13	2.58
1997	3.65	20.56	4.61	216.9	160.29	198.7	109.8	1.85	14.08	2.55
1998	4.23	22.80	5.53	231.4	171.3	212.5	107.0	1.95	14.25	2.78

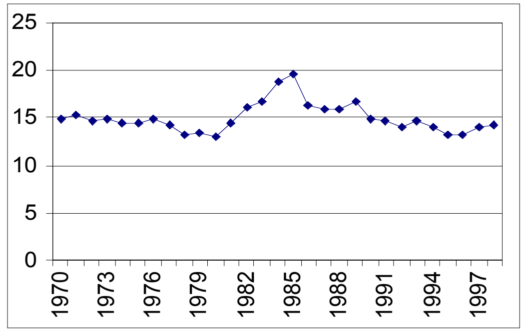
Source: International Financial Statistics, IMF

Figure 1. Real Exchange Rate*

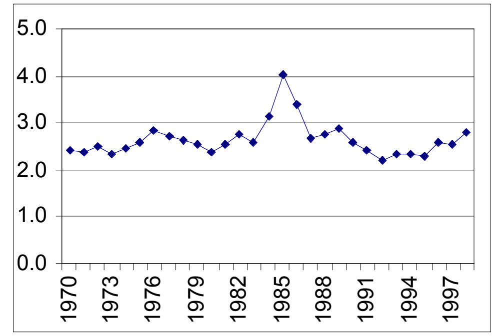
Botswana: Pula per U.S. Dollar



Mauritius: Rupees per U.S. Dollar



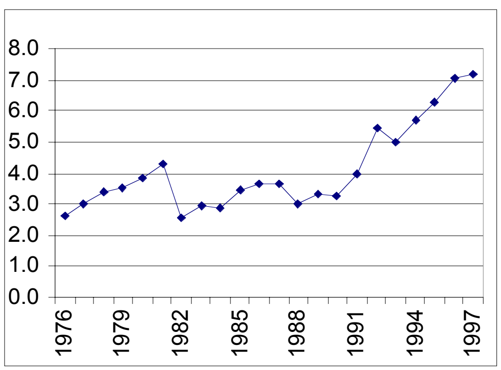
South Africa: Rand per U.S. Dollar



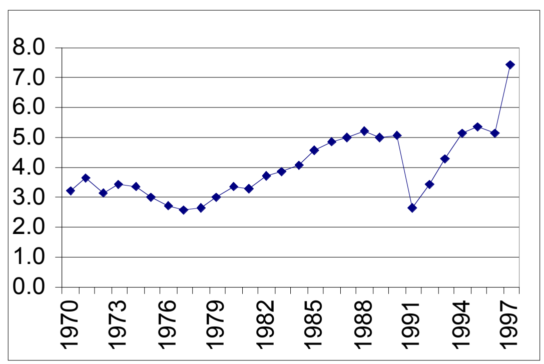
*Note: Real exchange rate is defined as the nominal exchange rate multiplied by the ratio of the USA PPI and the domestic CPI

Figure 2. Money Multiplier

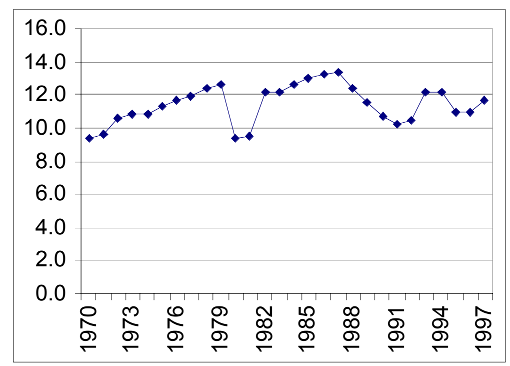
Botswana



Mauritius



South Africa



The data for Botswana and Mauritius provide evidence, at the aggregate level, that both countries have experienced broad-based financial development as they have grown rapidly. Some of the important elements of this dynamic process have been illustrated in Annex B where the author and Tzvetana Rakovski have tested the hypothesis proposed by Ronald McKinnon on the complementarity between financial deepening (as measured by the money/GDP ratio) and the rate of investment. As shown in the annex, there is strong support for the complementarity hypothesis, especially in Botswana, particularly as it relates to savings and financial deepening.

Tables 3, 4, and 5 report some of the same data for the other countries of Southern Africa. Table 3 shows the growth rate of real GDP and the ratio of broad money to GDP. The growth rates of real GDP have fluctuated widely although average growth rates have been low, particularly over the last decade and a half. For most countries the ratio of broad money to GDP rose during the 1970s and early 1980s in response to policies which encouraged financial deepening. Since the mid-1980s, that process has been reversed as many countries have experienced widespread financial disintermediation.

Table 4 reports the rate of inflation and the budget deficit (as a percent of GDP). The data for Angola reinforce a point made earlier. With high inflation and few basic numbers, financial development of any consequence will require the onset of peace and reconstruction. Overall, the inflation rates throughout Southern Africa have been high. Indeed, by current world standards, they remain high. Given the long history of budget deficits in each country, such a result is not surprising. This is a major concern that governments will have to address if there are to be improved prospects for broad-based financial development. In this respect, it is interesting to compare the data in Tables 3 and 4 for Zambia, Tanzania, and Zimbabwe. High inflation, largely due to deficit financing, has led to a decline in the ratio of money to GDP.

This outcome is evidence that most of the governments in Southern Africa have misunderstood the difference between finance capital and real capital (a point explained in Annex C). Their mistake has been to believe that money and credit will promote economic development. By failing to distinguish between financial and real resources they have allowed money and credit to expand at a rate well beyond that of the productive capacity of their economies. Rather than promote growth and development, the misuse of finance and credit has led to economic disruption and financial regression.

Table 5 reports gross domestic savings (GDS) and gross domestic investment (GDI) and implicitly the resource balance (measured as the difference between GDS and GDI). It is clear in Figures 3 and 4 that for most countries, that balance has deteriorated over time. Apart from Swaziland, the savings ratio has been low. During earlier periods, some countries, most notably Zambia, saved a large share of their national income. That share declined sharply over the last two decades as the economy regressed. One feature of Table 5 is that GDI has been relatively high across Southern Africa. This has occurred in the context of low and falling domestic savings. That is, investment has been sustained by drawing on foreign savings in the form of external loans or foreign aid.

Table 3. GDP Growth and Broad Money: Other SADC Countries and Madagascar

Year	Angola		Lesotho		Madagascar		Malawi		Mozambique		Namibia	
	GDP Growth (annual %)	Broad Money (% of GDP)	GDP Growth (annual %)	Broad Money (% of GDP)	GDP Growth (annual %)	Broad Money (% of GDP)	GDP Growth (annual %)	Broad Money (% of GDP)	GDP Growth (annual %)	Broad Money (% of GDP)	GDP Growth (annual %)	Broad Money (% of GDP)
1970	..	..	2.2	..	5.3	16.7	0.5	18.1	..	..	..	..
1971	..	..	5.1	..	3.9	17.1	16.2	17.1	..	..	..	..
1972	..	..	-0.2	..	-1.3	18.3	6.2	18.4	..	..	..	..
1973	..	..	26.4	..	-2.6	18.1	2.3	20.3	..	..	..	..
1974	..	..	11.0	14.3	2.0	16.3	7.2	21.7	..	..	..	..
1975	..	..	-13.5	15.1	1.3	17.0	6.1	22.5	..	..	..	..
1976	..	..	11.0	16.3	-3.1	17.3	5.0	19.9	..	..	..	..
1977	..	..	21.8	15.6	2.4	18.4	4.9	19.4	..	..	..	..
1978	..	..	18.3	16.6	-2.7	21.0	9.7	20.6	..	..	..	..
1979	..	..	2.9	21.2	9.9	18.8	4.4	19.6	..	..	..	..
1980	..	..	-2.7	30.0	0.8	18.2	0.4	18.0	..	..	..	..
1981	..	..	1.0	39.7	-9.7	19.4	-5.3	19.5	5.0	..	1.4	..
1982	..	..	3.6	44.2	-1.8	17.8	2.5	20.8	-6.9	..	-0.9	..
1983	..	..	-8.7	51.5	0.9	14.5	3.7	19.8	-15.7	..	-2.1	..
1984	..	..	2.7	51.3	1.7	13.8	5.4	19.9	-6.5	..	-0.1	..
1985	..	..	9.5	50.8	1.2	14.5	4.6	19.9	1.0	60.6	-0.6	..
1986	2.8	..	1.8	52.5	2.0	15.0	-0.2	19.9	-2.3	64.8	5.1	..
1987	7.9	..	5.1	49.1	1.2	14.6	1.6	22.6	14.7	27.1	3.6	..
1988	5.6	..	13.0	43.1	3.4	14.1	3.2	21.7	8.2	26.4	0.4	..
1989	0.4	..	12.7	39.0	4.1	15.5	1.3	19.9	6.5	26.5	1.6	..
1990	-0.3	..	4.0	36.0	3.1	15.8	5.7	18.5	1.0	28.2	-1.2	..
1991	0.7	..	0.7	38.5	-6.3	17.5	8.7	17.5	4.9	26.0	10.4	23.9
1992	-5.1	..	3.5	36.6	1.2	19.4	-7.3	20.0	-8.2	31.3	6.3	25.7
1993	-23.8	..	4.0	36.3	2.1	20.7	9.7	18.3	8.6	32.0	-2.0	30.1
1994	1.4	..	12.9	36.6	0.0	20.5	-10.2	22.4	7.5	29.3	6.7	30.9
1995	11.3	..	9.1	34.9	1.7	18.1	14.7	15.2	4.3	27.4	3.4	34.9
1996	11.6	..	12.7	33.1	2.1	17.4	10.7	14.3	7.1	23.7	2.9	39.0
1997	7.6	..	8.0	31.7	3.6	18.6	5.1	14.1	12.4	23.6	1.8	41.2

Sources: African Development Indicators, 1998/99, World Bank;World Development Indicators, 1999, World Bank; International Financial Statistics, IMF

Table 3 (continued) GDP Growth amd Broad Money: Other SADC Countries and Madagascar

Year	Swaziland		Tanzania		Zambia		Zimbabwe	
	GDP Growth (annual %)	Broad Money (% of GDP)	GDP Growth (annual %)	Broad Money (% of GDP)	GDP Growth (annual %)	Broad Money (% of GDP)	GDP Growth (annual %)	Broad Money (% of GDP)
1970	..	..	5.8	24.2	4.8	24.9	22.6	..
1971	13.7	12.7	4.2	26.7	-0.1	28.5	8.9	..
1972	5.4	12.9	6.7	27.7	9.2	24.7	8.3	..
1973	9.0	13.6	3.1	27.9	-1.0	23.7	2.6	..
1974	5.7	19.7	2.5	27.9	6.4	22.7	6.6	..
1975	13.9	23.9	5.7	29.2	-2.3	29.7	-1.9	..
1976	-2.1	29.5	6.6	28.4	6.2	29.1	0.5	12.5
1977	1.0	31.6	2.8	28.9	-4.6	33.3	-6.9	13.2
1978	1.3	34.6	2.9	29.2	0.6	29.7	-2.7	13.4
1979	3.1	33.5	1.2	38.1	-3.0	27.7	3.3	19.2
1980	10.7	27.7	0.8	41.6	3.0	28.4	14.4	25.0
1981	2.1	27.6	-1.1	42.1	6.2	27.1	12.5	23.6
1982	0.5	25.9	1.3	39.9	-2.8	31.8	2.6	24.3
1983	2.0	29.1	-0.4	42.5	-2.0	33.0	1.6	21.9
1984	6.2	29.9	2.5	35.4	-0.3	32.0	-1.9	22.1
1985	3.8	33.1	1.6	35.1	1.6	26.9	6.9	22.1
1986	12.3	30.2	2.7	33.9	0.7	23.8	2.1	21.4
1987	14.6	29.3	3.0	20.2	2.7	23.9	1.1	23.0
1988	6.6	28.0	4.4	17.4	6.3	27.0	7.6	22.5
1989	9.1	30.3	2.6	18.4	-1.0	25.5	5.2	22.3
1990	8.9	28.9	6.2	19.9	-0.5	19.7	7.0	21.6
1991	2.5	29.2	2.8	19.8	0.0	18.6	5.5	16.9
1992	1.3	31.0	1.8	22.1	-1.7	16.9	-9.0	15.6
1993	3.3	31.1	1.2	24.4	6.8	14.1	1.3	18.1
1994	3.5	29.8	0.6	24.8	-3.4	14.8	6.8	20.4
1995	2.7	26.2	3.6	25.1	-2.3	17.2	-0.7	24.0
1996	3.9	25.3	4.2	21.8	6.5	17.6	7.3	22.7
1997	3.7	25.9	3.3	19.7	3.5	16.9	3.2	25.1

Sources: African Development Indicators, 1998/99, World Bank;World Development Indicators, 1999, World Bank; International Financial Statistics, IMF

Table 4. Inflation and Budget Deficit: Other SADC Countries and Madagascar

Year	Angola		Lesotho		Madagascar		Malawi		Mozambique		Namibia	
	Inflation % (CPI)	Budget Deficit * (% of GDP)	Inflation % (CPI)	Budget Deficit * (% of GDP)	Inflation % (CPI)	Budget Deficit * (% of GDP)	Inflation % (CPI)	Budget Deficit * (% of GDP)	Inflation % (CPI)	Budget Deficit * (% of GDP)	Inflation % (CPI)	Budget Deficit * (% of GDP)
1970	..	..	..	..	2.9	..	..	..	..	..	..	..
1971	..	..	..	-1.1	5.4	..	..	-8.2	..	..	..	..
1972	..	..	..	-1.3	5.6	-2.0	..	-6.1	..	..	..	..
1973	..	..	..	5.3	6.1	-2.0	..	-5.7	..	..	..	..
1974	..	..	13.4	8.9	22.1	-2.0	..	-6.4	..	..	..	..
1975	..	..	14.2	-7.9	8.2	..	..	-9.2	..	..	..	..
1976	..	..	11.4	-10.0	5.0	..	..	-6.1	..	..	..	..
1977	..	..	16.7	-1.8	3.1	..	..	-6.2	..	..	..	..
1978	..	..	12.5	..	6.5	..	..	-9.3	..	..	..	..
1979	..	..	16.0	..	14.1	..	..	-8.7	..	..	..	..
1980	..	..	15.7	-7.4	18.2	..	..	-15.9	..	..	..	..
1981	..	..	12.4	..	30.5	..	11.8	-12.4	..	..	14.8	..
1982	..	..	12.1	..	31.8	..	9.8	-7.6	..	..	15.5	..
1983	..	..	17.5	..	19.3	..	13.5	-7.1	..	..	12.0	..
1984	..	..	11.0	..	9.9	..	20.0	-5.2	..	..	9.1	..
1985	..	..	13.3	..	10.6	..	10.5	-8.4	..	..	12.0	..
1986	..	..	18.0	..	14.5	..	14.0	-9.9	..	..	13.4	5.2
1987	..	..	11.8	-21.3	15.0	..	25.2	-8.8	..	..	12.6	-3.2
1988	..	..	11.5	-17.8	26.9	-3.5	33.9	-6.0	50.1	..	12.9	0.0
1989	..	..	14.7	-7.7	9.0	-4.1	12.5	-2.8	40.1	..	15.1	5.3
1990	..	..	11.6	-1.0	11.8	-0.9	11.8	-1.6	47.0	..	12.0	-1.1
1991	..	..	17.7	-0.6	8.5	-5.0	12.6	..	32.9	..	11.9	-2.7
1992	..	..	17.2	3.7	14.6	-6.2	22.7	..	45.5	..	17.7	-5.3
1993	..	..	13.1	5.7	10.0	-4.8	19.7	..	42.2	..	8.5	-4.5
1994	800.0	..	8.2	4.7	38.9	-4.0	34.7	..	63.2	..	10.8	..
1995	11011.1	..	9.3	2.9	49.1	-1.6	83.3	..	54.4	..	10.0	..
1996	905.3	..	9.3	2.2	19.8	-1.3	37.6	..	45.0	..	8.0	..
1997	111.1	..	..	2.1	4.4	..	9.2	..	5.5	..	8.8	..

Sources: African Development Indicators, 1998/99, World Bank;World Development Indicators, 1999, World Bank; International Financial Statistics, IMF

Table 4 (continued) Inflation and Budget Deficit: Other SADC Countries and Madagascar

Year	Swaziland		Tanzania		Zambia		Zimbabwe	
	Inflation % (CPI)	Budget Deficit * (% of GDP)	Inflation % (CPI)	Budget Deficit * (% of GDP)	Inflation % (CPI)	Budget Deficit * (% of GDP)	Inflation % (CPI)	Budget Deficit * (% of GDP)
1970	1.85	..	3.49	-4.0	0.0	1.9	2.09	..
1971	2.3	-2.1	4.8	-7.0	12.5	-16.4	3.0	..
1972	2.4	-4.4	7.6	-5.0	0.0	-13.1	2.8	..
1973	11.5	-8.4	10.4	-2.7	11.0	-16.8	3.1	..
1974	19.3	1.1	19.6	-5.3	10.0	3.4	6.6	..
1975	12.0	8.7	26.1	-9.8	9.0	-21.7	10.0	..
1976	6.5	-3.7	6.9	-7.4	16.7	-14.0	11.0	-5.5
1977	20.8	-3.3	11.6	-3.0	21.4	-13.2	10.3	-4.3
1978	8.5	-13.9	6.6	-6.0	11.7	-14.4	5.7	-10.7
1979	16.5	1.2	12.9	-11.4	10.5	-9.1	18.2	-10.4
1980	18.7	6.5	30.2	-9.6	14.3	-18.5	5.4	-8.8
1981	20.1	-10.0	25.7	-10.2	12.5	-12.9	13.2	-5.9
1982	10.8	-5.7	28.9	-11.3	11.1	-18.6	10.6	-10.5
1983	11.6	-3.2	27.1	-7.9	20.0	-7.8	23.1	-6.2
1984	12.9	-0.5	36.1	-6.6	22.2	-8.4	20.2	-10.1
1985	20.5	-3.5	33.3	-7.5	36.3	-15.2	8.5	-7.0
1986	13.7	-5.0	32.4	-5.8	56.5	-21.6	14.3	-7.7
1987	13.4	1.9	29.9	-4.7	47.4	-11.8	12.5	-10.9
1988	12.4	4.0	31.2	-2.4	51.0	-11.2	7.4	-8.8
1989	8.3	5.3	25.8	-2.3	123.6	-10.6	12.9	-8.0
1990	11.0	7.2	35.8	-1.8	107.0	-8.6	17.4	-6.8
1991	10.8	4.9	28.7	-4.4	93.2	-45.1	23.3	-9.3
1992	8.2	-1.5	21.8	0.7	169.0	-6.6	42.1	-13.9
1993	17.0	-5.3	25.3	-4.2	188.1	-7.8	27.6	-10.7
1994	14.3	-5.2	33.1	-4.5	53.6	-4.0	22.3	-1.6
1995	14.7	1.5	29.8	-2.1	34.2	-7.2	22.6	-7.3
1996	12.5	4.1	19.7	-0.4	46.3	0.7	21.4	-4.3
1997	9.8	0.0	16.1	1.8	24.8	1.6	18.8	-5.7

Sources: African Development Indicators, 1998/99, World Bank;World Development Indicators, 1999, World Bank; International Financial Statistics, IMF

Table 5. GDI and GDS: Other SADC Countries and Madagascar

Year	Angola		Lesotho		Madagascar		Malawi		Mozambique		Namibia		Swaziland	
	GDI	GDS	GDI	GDS	GDI	GDS	GDI	GDS	GDI	GDS	GDI	GDS	GDI	GDS
	(percent of GDP)		(percent of GDP)		(percent of GDP)		(percent of GDP)		(percent of GDP)		(percent of GDP)		(percent of GDP)	
1970	..	..	11.6	-31.9	9.9	7.5	25.7	10.8	..	..	..	..	19.2	25.1
1971	..	..	15.8	-42.6	11.2	4.6	19.2	7.1	..	..	..	..	19.9	31.4
1972	..	..	15.2	-49.9	8.8	4.8	24.4	9.7	..	..	..	..	22.3	30.2
1973	..	..	18.6	-45.9	9.1	4.5	22.4	12.4	..	..	..	..	23.4	38.1
1974	..	..	17.7	-66.0	8.7	4.0	27.3	16.4	..	..	..	..	26.9	49.5
1975	..	..	18.7	-70.4	8.1	3.1	33.7	17.0	..	..	..	..	17.8	33.9
1976	..	..	36.1	-83.3	8.1	5.8	26.3	17.8	..	..	..	..	29.6	37.7
1977	..	..	25.0	-74.5	8.1	4.5	24.7	20.1	..	..	..	..	27.0	23.7
1978	..	..	25.9	-47.4	9.6	2.7	38.4	20.5	..	..	..	..	43.9	22.1
1979	..	..	34.6	-66.2	16.1	0.3	30.2	12.6	..	..	..	..	39.7	6.6
1980	..	..	42.5	-59.3	15.0	-1.4	24.7	10.8	8.3	-8.4	29.2	38.9	30.3	6.5
1981	..	..	43.1	-68.1	11.5	0.2	17.6	11.8	22.7	-0.1	29.2	9.7	31.1	6.2
1982	..	..	49.3	-73.5	8.5	-1.0	21.4	15.1	22.8	-3.9	21.1	6.6	32.3	11.6
1983	..	..	33.7	-99.2	8.4	1.4	22.8	15.2	20.2	-5.2	19.8	7.3	30.0	5.6
1984	..	..	41.7	-93.7	8.6	4.0	12.9	14.8	22.0	0.0	17.0	6.0	33.4	10.8
1985	18.0	28.2	49.4	-76.8	8.5	1.3	18.6	12.9	17.0	3.8	11.0	22.1	26.2	4.7
1986	18.4	19.1	46.1	-73.5	9.0	6.9	12.3	10.1	16.3	1.6	8.8	18.0	20.0	16.9
1987	18.5	30.0	45.4	-70.0	10.1	5.9	15.7	13.3	36.1	-2.4	15.3	6.1	14.8	26.3
1988	11.8	22.7	47.9	-69.0	13.3	7.1	18.7	9.2	21.3	-10.9	16.1	21.5	23.6	29.0
1989	12.2	26.9	60.6	-46.5	13.4	9.8	21.2	4.7	20.8	-12.7	16.1	21.8	23.2	11.9
1990	11.7	29.7	70.7	-30.5	17.0	6.3	19.7	9.7	21.9	-8.7	24.2	13.7	19.6	20.4
1991	12.9	16.2	80.2	-49.4	8.2	0.7	20.1	12.4	22.5	-6.7	19.1	9.9	20.6	18.2
1992	3.6	1.7	78.3	-45.5	11.3	3.4	18.8	0.1	27.1	-8.0	21.0	11.8	26.1	18.6
1993	26.4	25.2	75.0	-33.2	11.4	2.5	12.2	-4.2	26.5	-11.4	16.3	9.8	26.6	26.3
1994	23.2	32.7	80.3	-14.6	10.9	3.4	29.1	8.2	31.3	-4.8	23.3	18.3	32.1	26.0
1995	25.0	15.7	83.2	-16.9	10.9	3.6	16.9	8.2	36.1	10.6	20.8	9.8	34.1	29.0
1996	22.7	20.2	89.2	-1.8	11.1	5.8	12.6	0.8	30.1	9.4	20.4	11.8	32.1	23.4
1997	24.7	27.3	85.5	-10.0	12.5	4.7	12.7	5.5	29.5	13.6	18.5	13.6	28.4	20.1

Source: African Development Indicators, 1998/99, World Bank

Table 5 (continued) GDI and GDS: Other SADC Countries and Madagascar

Year	Tanzania GDI (percent of GDP)	Tanzania GDS	Zambia GDI (percent of GDP)	Zambia GDS	Zimbabwe GDI (percent of GDP)	Zimbabwe GDS
1970	..	..	28.2	45.1	..	..
1971	..	..	37.3	35.2	..	..
1972	..	..	35.6	37.2	..	..
1973	..	..	28.9	44.7	..	..
1974	..	..	36.9	46.5	..	..
1975	..	..	40.9	21.2	26.3	25.1
1976	..	..	31.5	36.4	17.9	21.8
1977	..	..	24.7	22.1	19.1	21.5
1978	..	..	23.9	20.5	11.9	15.4
1979	..	..	14.1	23.1	12.7	12.5
1980	..	..	23.3	19.3	16.9	13.8
1981	29.2	19.1	19.3	6.8	22.7	26.9
1982	25.4	16.6	16.8	8.0	22.7	26.9
1983	19.6	12.1	13.8	15.2	22.7	26.9
1984	16.4	9.4	14.7	16.5	22.7	26.9
1985	17.7	8.7	14.9	14.1	22.7	26.9
1986	19.3	6.3	23.8	22.1	22.7	26.9
1987	24.4	2.8	12.7	16.5	17.2	21.4
1988	18.7	1.3	11.1	18.2	18.7	22.1
1989	17.4	1.3	10.8	3.8	15.0	16.7
1990	22.6	0.3	17.3	16.6	17.4	17.4
1991	26.2	-0.6	11.0	8.4	19.1	15.8
1992	26.8	-1.6	11.9	-0.3	20.2	11.0
1993	26.1	-2.8	15.0	8.9	22.8	21.0
1994	24.9	-2.0	13.4	8.9	24.1	22.2
1995	21.9	0.0	13.9	7.7	23.2	20.8
1996	18.0	3.4	14.9	8.9	25.9	25.8
1997	21.0	3.0	15.0	9.1	25.1	19.1

Source: African Development Indicators, 1998/99, World Bank

Figure 3. Gross Domestic Investment (percent of GDP)

Botswana **Mauritius** **South Africa**

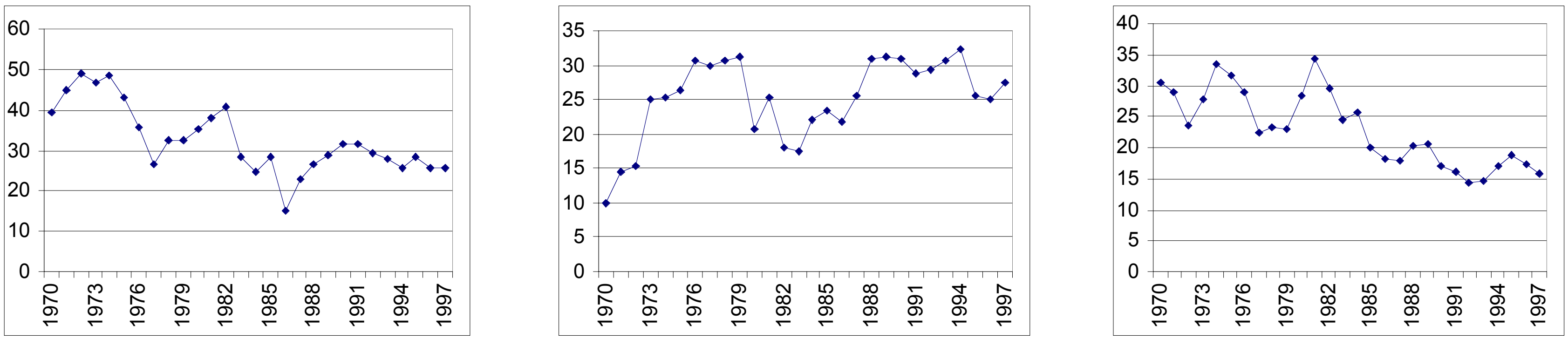
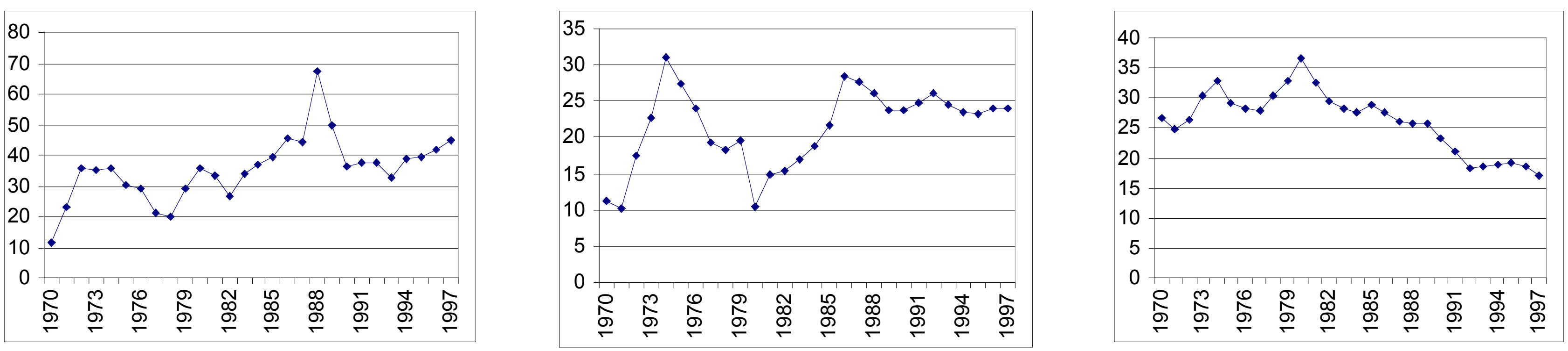


Figure 4. Gross Domestic Savings (percent of GDP)

Botswana **Mauritius** **South Africa**



The patterns evident in these tables have several implications. First, few of the countries discussed have deep or dynamic financial systems. Despite the financial sophistication of its major institutions, even South Africa has experienced some financial regression.

Second, many of the countries of Southern Africa have economic problems that extend well beyond the lack of financial development. For example, Mozambique and Tanzania are recovering from broad-based collapse—the former induced by civil war, the latter by macroeconomic mismanagement. Other economies, such as Zambia and Zimbabwe, continue to deteriorate.

Third, *all* countries being studied could benefit from policies that reduce the rate of inflation. Relative to the rest of the world, countries in Southern Africa have significantly higher rates of inflation. High inflation erodes confidence and typically leads to an appreciation of the real exchange rate. Both of these undermine financial development.

Fourth, the low rates of domestic saving and heavy dependence by many countries on donor support are compelling arguments *for* rapid financial development. Such a change would help countries mobilize more resources domestically and strengthen their regional linkages. This would enable development to be financed from within Southern Africa, thereby moving the whole region beyond its chronic aid dependency.

Fifth, the potential for financial development throughout Southern Africa remains largely untapped. While there are many positive signs that entrepreneurs and financial enterprises in Botswana and Mauritius are intent on expanding throughout Southern Africa, what is not clear is whether that can and will happen.

c. The Demand for Financial Services

While the data just reviewed suggest a pressing need for financial development throughout Southern Africa, the basic issue is how this need is to be met. Some countries are already attempting to foster financial development (as part of a more general program of promoting growth and development). They are stabilizing their economies, reviving confidence, and laying the foundation for significant increases in investment and growth. Countries further along in the process are attempting to create the institutional setting to support the expanded demand for financial services.

The outcomes have been consistent with experience in other regions of the world. In Africa, as elsewhere, the demand for financial services is determined by the growth of wealth and income; the prevalence and nature of the risks associated with financial assets and financial transactions; the quality of the financial infrastructure (including the efficiency of the payments system); the impact of financial (and other) regulations on transactions costs and the viability of financial markets; the legal setting, especially contract enforcement; and the overall degree of political stability.

Unraveling the relative importance of these factors would require a detailed modeling exercise for each country and the subregion. (Annex B provides some results using data for Botswana and Mauritius.) International experience, however, also suggests that major reasons for the limited degree of financial development across Southern Africa are low (and often falling) real incomes and macroeconomic instability.[11] The former limits the growth of the demand for financial services. The latter increases risk, undermines confidence, and reduces the attractiveness of financial assets relative to real property and foreign exchange.

The importance of demand factors as principal determinants of financial development is worth emphasizing. Throughout history, financial development has rarely, if ever, been driven by supply factors. The so-called information revolution and the globalization of financial markets have not changed this. If anything, these developments reinforce the point. With improved communications and financial globalization, all developing countries now have access to a much broader supply of financial services than ever before. The existence of this supply, however, has not stimulated financial deepening. That, as experience has shown, is fundamentally driven by the demand side.

Furthermore, as noted earlier, Southern Africa already has some world-class financial institutions that could supply significantly more financial services than at present. The Johannesburg Stock Exchange is a first-rate organization. South Africa's largest banks, brokerage firms, insurance companies, and finance houses are part of the global financial system. Many of the financial institutions in Mauritius are owned in part by organizations that have a major presence in world financial markets. Botswana's commercial and merchant banks have direct links with London and Johannesburg. Zambia and Zimbabwe have branches of banks and insurance companies that are owned by international financial enterprises. Moreover, all countries within Southern Africa have a long history of promoting a wide range of financial enterprises, particularly "development" banks. None of these has been noteworthy for its success. The implication is that if supply factors had been the principal determinant of financial development, Southern Africa would already be in the forefront of financially developed areas. That it is not simply reinforces the importance of demand factors.

Future financial development in Southern Africa will continue to be demand-driven. Demand for financial services, in turn, will rise as the broader conditions for macroeconomic stability emerge. How that might materialize is the subject of numerous studies and will not detain us here.[12]

One reason why financial systems in Southern Africa are not more highly developed is that the supply of savings has been low. With low savings there have been few asset-holders to demand the types of services that would stimulate the development of a progressively deeper financial system. As the data above show, Botswana is the only country with a savings rate approaching the rates achieved in rapidly growing countries in other regions. Even Mauritius has not had a rate of savings comparable to those of the "Asian tigers."[13]

A further reason for lack of financial development in Southern Africa is that most countries can obtain large amounts of their investment resources from abroad. The bulk of these resources are supplied by donor agencies. Financial development in Southern Africa would be given a major boost if (and when) countries that are now so highly aid-dependent began actively seeking ways to move beyond aid. None of the countries now acutely dependent on aid has yet adopted an aid exit strategy. Were they to do this, their policymakers would find their attention shifting to activities for mobilizing resources locally and allocating them to activities that have the highest returns. This would bring into bold relief the need for rapid financial development.

d. Overview

The above discussion has illustrated that South Africa is unlikely to provide the impetus for financial development in Southern Africa at least in the short to medium term. Botswana and Mauritius are perhaps the best placed to achieve rapid increases in their rate of financial development. The basic question to which we now turn is whether the financial initiatives being taken in Botswana and Mauritius will help stimulate financial development elsewhere in Southern Africa.

3. Financial Development in Mauritius

The Government of Mauritius (GoM) has pursued a high-growth strategy over the last two decades based on the production of textiles and sugar and the provision of “high-end” services for tourists.[14] As a means of sustaining rapid growth, senior government officials have sought activities suited to the country’s resource base, the skills of its population, and its location. One such strategy—the so-called “fourth pillar”—is to promote Mauritius as a financial services center. The first step in this direction was taken with the passage of the Banking Act 1988. This Act, which replaced the Banking Act 1971, gave legislative backing for the emergence of offshore banking.[15] Since then there has been a series of changes focusing primarily on the liberalization of the financial system (with the full lifting of exchange controls in July 1994); expanding the range of financial services that can be offered and the number of agencies involved; and strengthening oversight and supervision throughout the whole financial system.

To date, legislative and regulatory changes have been made as the financial system has evolved.[16] For example, the Companies Act was amended in 1990 to enable offshore nonfinancial companies to operate in Mauritius. In 1992, the Mauritius Offshore Business Activities Act and Offshore Trust Acts were passed. The former established the Mauritius Offshore Business Activities Authority, which has the role of promoting Mauritius as a financial center and supervising the operations of all nonbank offshore companies. This evolutionary process has served Mauritius well. It has provided flexibility and enabled financial enterprises to respond to new opportunities as they arise. It has also allowed the authorities to revamp and modify the system of supervision and monitoring in light of experience and new developments.[17] The Financial Services Act, which is now working its way through various government agencies, seeks to build on experience from both Mauritius and abroad.

Recent rapid advances in information technology and telecommunications have encouraged the Government of Mauritius to seek ways of using the power of information technology as a foundation for the expansion of financial services. The government hopes to exploit the connection between the two. This is illustrated in the national long-term perspective study that produced the *Vision 2020* report. The government sees "international [financial] services" as providing "the extra boost" to the economy. The report noted that

> there is a growing tendency for banking, insurance, and other financial services to go offshore to take advantage of a more favourable fiscal or legal regime, or a more stable economy or government. Mauritius is well placed to provide these services for the developing economies around the Indian Ocean rim on account of: its relatively inexpensive but well educated labour force; fluency in French, English, and a number of other languages; good supporting infrastructure and communications; efficient public administration; open economy; and political and social stability.[18]

The report also stresses the key elements essential for the operation of offshore financial centers identified in other studies. For example, an International Monetary Fund (IMF) study comparing the advantages offered by Mauritius relative to the other offshore centers highlighted three requisites: "strategic geographic location, political stability, and a conducive regulatory framework."[19]

Mauritius offers all of these. The IMF report (written in 1995) suggested that with Port Louis 3500 miles from Mumbai and 2000 miles from Johannesburg, Mauritius' locational advantages are questionable. Yet, since advances in information technology have led to the "collapse of distance" (the very point stressed by the GoM), it is difficult to see that Mauritius is seriously disadvantaged by its isolation. Indeed, in view of the demise of Panama and Bahrain as offshore financial centers following regional disturbances, Mauritius may prove to have the ideal location. It has no neighbors to create adverse spillover effects.

Since opening up to offshore activities, there has been considerable expansion in the asset base, volume of transactions, and income earned by the enterprises engaged. There has also been a large increase in the number of companies that have taken advantage of the opportunity to register their operations in Mauritius. The *Annual Report 1997–98* of the Bank of Mauritius (BoM) noted that as of June 30, 1998, there were nine offshore banks in operation.[20] Their assets were US $1022 million, an increase of 44 percent over the previous year.[21] Net interest income from their operations was $10.4 million, while operating income was $16 million. Operating profit was $11.8 million, while net profit (after allowing for bad and doubtful debts) was $10.2 million. This represents a return on assets of 1 percent and a return on equity several multiples higher.

In addition to banking, the offshore sector has enterprises engaged in, among other things, brokerage operations, factoring, insurance, financial data services, and asset management. Perhaps the most successful activities so far have been those established to channel resources into India consistent with the advantages provided by the Indo-Mauritian double taxation agreement.[22] That arrangement, which was established before Mauritius became an offshore financial center, enables Indian firms registered in Mauritius to avoid Indian taxes on their investments in India. The finance provided under this umbrella has been so large that Mauritius is now considered to be a major source of external investment in India.

a. Current Strengths of the Financial System in Mauritius

The financial system in Mauritius has several strengths. These include an increasingly sophisticated domestic financial system; enterprising financiers who have been aggressively expanding their interests and contacts in Southern Africa; a relatively strong system of financial supervision and oversight; and a stable political system that provides a conducive setting for business and finance.

Sophisticated Financial System: Several key dimensions of the financial system have already been noted. The money to GDP ratio is high and has been rising over time.[23] The number of domestic and offshore financial institutions has increased and the range of services being demanded has expanded. Mauritian financial institutions channel large amounts of resources to India and other countries on the Indian Ocean rim. In 1988, GDP generated in financial services was 3.4 percent of GDP. By 1997, it had risen to 9.8 percent of GDP.[24] Thus far into the 1990s, the dollar value of assets in offshore companies has increased by a factor of thirty. The point is clear: though it is not financially developed by world standards, Mauritius is making rapid progress in that direction.

Enterprising Financiers: Mauritian businesses and banks have taken a number of initiatives in Madagascar and on the mainland. Beginning in the late-1980s, enterprises operating in Mauritius' export processing zone moved some of their more labor-intensive operations to Madagascar. This transfer was both industrial and financial. (Annex A provides further details.) Indeed, the State Bank of Mauritius has been gaining market share in Madagascar. With the end of the civil war in Mozambique, Mauritian businesses and financial enterprises have taken a special role in helping that country recover.[25] Mauritian sugar companies have been helping rehabilitate the sugar industry; manufacturing enterprises have been granted a special dispensation to set up export processing operations; and Mauritian banks have been actively seeking opportunities to finance trade and investment and to provide personal and commercial financial services. Mauritian financial enterprises have also been exploring opportunities for expansion in Tanzania.

One approach adopted by Mauritian banks as they seek new opportunities abroad is to form "strategic alliances." These involve a Mauritian bank forming a partnership with a European and a South African–based bank to establish banking operations in three countries. Such alliances provide the new operation with access to the financial resources and managerial skills needed to become firmly established. They also help reduce operating risk by providing the partner institutions with a degree of political/diplomatic "cover" in countries that are still in the process of "opening up."

Relatively Strong Supervision: Financial supervision in Mauritius is the responsibility of the Bank of Mauritius (BoM), the Comptroller of Insurance, the Mauritius Offshore Business Activities Authority, and the Stock Exchange Commission. For several years Mauritian authorities have been discussing ways of rationalizing and consolidating financial supervision. The intention is for banks and deposit-taking organizations to be supervised by the BoM with the proposed Financial Services Authority taking responsibility for all other financial entities. While preparations are being made, the BoM has continued to ensure that the enterprises subject to its oversight meet all legal requirements, undergo regular inspections, and operate prudently.[26] All domestic banks in Mauritius are required to meet the Basle Accords on capital adequacy.[27] The BoM also adopted the Core Principles for Effective Banking Supervision in September 1997.[28] Those principles provide an internationally accepted framework for banking supervision. Furthermore, under the Basle Concordat of 1975, the BoM can depend on the central banks of the key industrial countries to ensure that the affiliates of the major international banks operating in Mauritius are adequately capitalized and properly supervised.

Stable Political System: Mauritius is a multiparty democracy. It has no army and its human rights record is exemplary. All political parties are deeply committed to rapid economic growth and social stability. This is an area where Mauritius' isolation is an advantage. Mauritius is close to, but not part of, the African continent. It thus has the advantage of proximity to Africa without the risk of "neighborhood" effects.

b. Current Weaknesses of the Financial System in Mauritius

There are a number of difficulties. The more prominent of these include a chronic budget deficit, persistent wage pressures (which undermine competitiveness), and (so far) a limited presence throughout Southern Africa.

Chronic Budget Deficit: The budget deficit is only one of a number of macroeconomic weaknesses in Mauritius (Table 6). Others include

- inflation, which is high relative to Mauritius' trading partners;
- a rapid increase in domestic debt (i.e., the debt has risen over several years, with its rate of growth well in excess of the growth of GDP);
- a sharp increase in domestic credit reflected in a high growth rate of the money supply;
- a persistently high nominal interest rate (that raises government expenditure on debt service);
- real wages rising at rates above the growth of productivity; and
- an appreciating real exchange rate (until recently).[29]

These pressures at the macroeconomic level have been emerging for several years. The GoM has been slow to address them. They are already having an impact on the ability of Mauritius to compete internationally, especially in the wake of the massive real exchange rate depreciation across Asia in mid-1997. If these trends persist, they will undermine growth in Mauritius.

One problem that has prevented Mauritius from dealing effectively with these adverse trends has been the general lack of coordination in macroeconomic management. This may be somewhat surprising given that Mauritius has done so well.

Table 6. Mauritius: Selected Macroeconomic Indicators

	1970	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997
GDP at 1995 Prices (in billions USD)	0.98	1.74	1.84	1.94	1.95	2.04	2.18	2.4	2.61	2.79	2.91	3.12	3.25	3.45	3.64	3.79	3.97	4.18	4.39
Real GDP Growth (%)	-0.4	-10.1	5.9	5.5	0.4	4.7	7	9.7	8.9	6.8	4.5	7.2	4.3	6.2	5.4	4.1	4.7	5.4	5
Real GDP Per Capita Growth (%)	-2.1	-11.6	4.5	4.3	-0.6	3.9	6.3	8.9	8.1	6	3.7	6.4	3.3	4.9	4	2.6	3.9	4.4	3.8
Gross Domestic Investment (% of GDP)	9.9	20.7	25.3	18.2	17.5	22	23.5	21.9	25.6	31	31.1	30.9	28.7	29.3	30.7	32.3	25.7	25.1	27.6
Gross Domestic Savings (% of GDP)	11.2	10.5	14.8	15.4	17.1	18.7	21.6	28.6	27.6	26.1	23.8	23.6	24.9	26.1	24.5	23.4	23.2	23.9	24.1
Budget Deficit, Incl. Grants (% of GDP)	..	-10.3	-12.7	-11.8	-7.7	-4.5	-3.5	-1.8	0.2	0.3	-1.4	-0.4	0	-0.7	0	-0.3	-1.2	-4	-4
Export of Goods & Services (% of GDP)	43.2	51.2	44.7	47.2	46.6	48.7	53.5	60.5	64.6	64.7	64.2	65.2	62.9	60	59.4	57.6	59.7	63.9	62
Import of Goods & Services (% of GDP)	41.9	61.4	55.2	50	47	52	55.4	53.8	62.5	69.7	71.5	72.5	66.6	63.2	65.6	66.5	62.2	65.2	65.5
Current Account Balance (% of GDP)	..	-10.3	-12.9	-3.8	-1.8	-4.9	-2.7	6.4	3.5	-2.6	-4.7	-4.5	-0.6	0	-2.9	-6.6	-0.6	0.7	-2.6
Exchange Rate (Rupees/USD, p.a.)	5.6	7.7	8.9	10.9	11.7	13.8	15.4	13.5	12.9	13.4	15.3	14.9	15.7	15.6	17.6	18	17.4	17.9	20.6
Parallel Market Ex. Rate (rupees/USD, p.a.)	..	..	..	..	..	..	14.4	14.3	13.7	14.1	16	15.7	17.1	16.8	18.3	18.4	18.2	19.4	21.4
Money and Quasi-Money (% of GDP)	35.2	40	38.3	38	40.6	40.5	43.2	47.4	49.9	54.4	56.9	57.1	61.5	65.1	66.8	68.5	72.3	72.8	73.5
Broad Money Growth (annual %)	13.9	23.2	4	23.4	10.1	14.2	31.5	29.1	29.8	28.7	15.4	21.2	21.9	15.9	17	12.3	18.7	7.6	16.4
Inflation, Consumer Prices (annual %)	1.7	42	14.5	11.4	5.6	7.4	6.7	1.6	0.5	9.2	12.7	13.5	7	4.6	10.5	7.3	6	6.6	6.8
Inflation, GDP Deflator (annual %)	1.6	26.6	10.9	8.9	8.4	7.5	8.2	8	12.9	10.9	11	10.1	8.2	5.5	7.8	7.2	4.7	6.1	5.9
Food Production Index (1989-91=100)	81	78	88	106	89	87	96	103	105	98	96	101	102	107	105	99	103	109	..
Population Growth (annual %)	1.7	1.5	1.4	1.2	1	0.8	0.7	0.9	0.8	0.8	0.8	0.8	0.9	1.3	1.5	1.4	0.8	1.1	1.2
Net ODA, All Donors (in billions USD)	..	0.03	0.06	0.05	0.04	0.03	0.03	0.05	0.06	0.06	0.06	0.09	0.07	0.05	0.03	0.01	0.02	0.02	0.04
External Debt, Total (in billion USD)	0.03	0.47	0.54	0.58	0.56	0.55	0.63	0.67	0.82	0.87	0.85	0.99	1.04	1.05	1.01	1.38	1.76	1.82	2.47

Sources: World Development Indicators, World Bank, 1999; International Financial Statistics, IMF, 1998; African Development Indicators, 1998/99

Macroeconomic management covers the key aspects of fiscal and monetary policy, exchange rate management, and debt management that determine the ability of an economy to achieve and sustain high rates of growth and development. Mauritius, like many other countries, follows a "traditional" approach to economic policy in which the various issues related to fiscal and monetary policy, exchange rate management, and debt management are compartmentalized. Communication among all officials in these areas normally improves during the budget season but is irregular at other times. Even if it appears to have worked in the past, such an approach to macroeconomic management is unsatisfactory.[30]

One area where the lack of coordination has created problems has been in financial management. With the shift away from direct controls to indirect management of the monetary system, the BoM staff relies on a monetary programming framework to help them determine targets for reserve money growth.[31] A key element in that program is the inflation projection. For 1998 the projection used was 8 percent, a figure that had no relation to inflation in the rest of the world or the government's general commitment to keep prices under control. In the absence of direct consultations between government and BoM staffs on the desirable rate of inflation, the BoM proceeded to provide the growth of reserve money consistent with the targeted rate of inflation. This rate, however, was well above what the economy should have experienced.

The Role of Information Technology: The GoM has repeatedly stressed the importance to Mauritius of adopting state-of-the-art information technology as part of its strategy to support the country's ambitions for growth and development in a global setting. For example, the Budget Speech of 1997/98 indicated that the government was committed to linking all Mauritians to the Internet. In support of this, the financial community has made significant progress upgrading its capacity to provide electronic banking and to foster the broader use of electronic commerce and data services.

What is not clear from the GoM's position, however, is how the investment in information technology is meant to complement the development of financial services. Who is supposed to anticipate what technology the financial services sector will require to expand and how? Thus far, the financial services sector in Mauritius has developed rapidly by taking advantage of opportunities as they arise, with the GoM responding (via changes in legislation and regulations) as pressures build on the system. In the case of information technology, however, the GoM has given strong support to the adoption of a "supply-leading" approach. Given the rate of obsolescence in the information technology industry, this strategy may be extremely costly especially if significant parts of the expansion in financial services are generated on mainland Africa, where the fundamental limits to financial deepening are income and wealth rather than the capacity to communicate rapidly.

Before the GoM makes decisions that could lead it down an expensive technological dead end, it might be advisable to spend more time strengthening the foundation of e-banking and e-commerce, which already exists. One place to start would be to begin to spread the Internet culture throughout the bureaucracy so that decisions made within the government will enhance the activities of private business, not inhibit them. If financial services are to become the "fourth pillar," officials have to begin to anticipate some of the potential problems and respond to them.

An example that illustrates the point is an area where the law seriously lags behind established practice. Bank transactions need to be “duly authorized,” which under present and proposed banking law means obtaining a customer’s signature. Yet, electronic banking operates on personal identification numbers (PINs) protected by sophisticated encryption codes. In principle, banks that allow transactions to proceed on the basis of PINs are operating outside the law. This example is one of the many disconnects that exist between the actions of government (as embodied in law) and practical developments on the ground.

Further problems have emerged as cost savings generated using e-banking and e-commerce have not been realized. The spread of the Internet has shifted banking operations “away from the counter.” For some banks in Mauritius, more than two-thirds of all transactions now occur “away” from the bank branches. E-banking, ATM machines, and automatic billing arrangements have led to significant excess capacity in the branch network. In fact, many banks are using branches for selling financial products. That is, they have become “sales points” rather than “service points.” Problems arise from (and for) politicians when the rationalization of banking operations results in the closure of branches (and installation of ATM machines) because of the direct impact on employment within their constituencies.[32]

If Mauritius is to benefit from the lower transactions costs provided by information technology, “habitual modes of thought” and hard-core political concerns have to be overcome. These issues need to be addressed so that resistance to the spread of the Internet does not begin raising costs undercutting any cost advantage that Mauritius may have as a financial center.

4. Financial Development in Botswana

Botswana is well advanced in preparing the foundation for becoming an international financial services center. The Presidential Task Force on Vision 2016 noted: “Botswana is in a good position to become a regional and international finance and banking centre. Financial institutions must find more innovative ways to support the development efforts.”[33]

Details of how this will be done were given in the 1999 Budget Speech. The minister of finance noted:

> As a result of economic liberalization, as well as the maintenance of macroeconomic balance, Botswana is now in a position to establish itself as an International Financial Services Centre. In this regard, Government appointed an international consultancy team last year, under the supervision of the Botswana Development Corporation, to assist in the implementation of the project.[34]

He continued:

> Once established, the Centre will be expected not only to create jobs for Botswana, but also to enhance training opportunities. The Centre should also contribute to Government revenues; facilitate inward investment into productive sectors; as well as have spin-off

effects in skills development in such areas as the legal, administrative, accounting, financial, and computing professions.

The GoB planned to pass the relevant legislation during 1999.

The development of the financial services center has drawn heavily on the model provided by the Republic of Ireland. This reflects the experience of the personnel hired to help plan the center and Ireland's success in the endeavor. Ireland promoted itself by emphasizing its proximity to London, its membership in the European Union, and its overall economic performance.[35] In addition to international banking services, Ireland has been successful in areas related to large-scale leasing (particularly of aircraft), asset management, and statistical services.

During the initial stages, supporters of Botswana's initiative anticipate that the main interest will come from financial enterprises from South Africa wishing to use Botswana as a stable, low-tax setting that is close to but not part of South Africa.[36] Gaborone has excellent connections to Johannesburg, Pretoria, and Cape Town and is well linked to all countries in Southern Africa. The conditions offered to financial entities that become established in Botswana are: corporate tax of 15 percent; exemption from withholding taxes in Botswana; and access to Botswana's (expanding) double tax treaty network. Each enterprise is subject to an approval process, which is based on the following criteria.[37] The enterprise

- must provide financial services, such as banking, funds management and/or administration, insurance services, financial advisory services, and trading or brokering of financial services;

- make an employment commitment commensurate to the scale of the proposed activities;

- operate "offshore," i.e., involve nonresidents in currencies other than the pula; and

- each project must satisfy the regulatory requirements of the Botswana authorities.

It is too early to determine whether Botswana will be attractive as a financial services center. However, with the passage of legislation this year, the necessary incentives and logistics will be in place.[38]

a. Current Strengths of the Financial System in Botswana

Botswana has a number of evident advantages in its quest to become an international financial services center. These include macroeconomic stability, proximity to South Africa, and growing experience in asset management.

Macroeconomic Stability: The data presented earlier show that the macro economy of Botswana has performed extraordinarily well over the last two decades (Table 7). It helps to have some of the most productive diamond mines in the world and special dispensation to export beef to the European Union. But, as the experience of other countries in Africa has shown, having resources

Table 7. Botswana: Selected Macroeconomic Indicators

	1970	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997
GDP at 1995 Prices (bill. USD)	0.33	1.41	1.54	1.65	1.92	2.14	2.29	2.47	2.69	3.1	3.5	3.7	4.02	4.28	4.27	4.45	4.58	4.9	5.24
Real GDP Growth (%)	15.8	14.3	9.5	7.5	16	11.5	7.2	7.5	8.9	15.3	13.1	5.6	8.7	6.3	-0.1	4.1	3.1	7	6.9
Real GDP Per Capita Growth (%)	12.5	10.7	5.9	3.9	12.5	8	3.7	4	5.5	11.9	9.9	2.5	5.7	3.5	-2.8	1.5	0.7	4.5	4.5
Gross Domestic Investment (% of GDP)	39.6	35.3	38.1	40.9	28.2	24.7	28.5	15.2	23	26.7	29	31.8	31.6	29.4	27.9	25.5	28.2	25.8	25.9
Gross Domestic Savings (% of GDP)	11.3	35.7	33.3	26.5	33.6	37	39.4	45.4	44.4	67.1	49.9	36.2	37.8	37.7	32.9	38.7	39.1	41.9	44.7
Budget Deficit, Incl. Grants (% of GDP)	..	-0.2	-2	-2.1	8.4	12.7	21.2	20.9	16.8	19.5	9.8	12.1	10.2	10.7	10	1.9	2.8	9.4	..
Export of Goods & Services (% of GDP)	21.3	49.8	49.7	44.6	57.8	59.6	55	67.2	61.3	76.9	63.4	56	54.9	51.9	44.7	48.7	47.8	51.3	56.4
Import of Goods & Services (% of GDP)	49.6	49.5	54.4	59	52.4	47.2	44.1	37	39.8	36.5	42.5	51.5	48.8	43.6	39.7	35.5	36.9	35.3	37.5
Current Account Balance (% of GDP)	..	-14.6	-25.3	-13.9	-7	-4.5	6.8	8	38.2	8.1	16.8	1.2	8.6	6.2	12.3	5.5	7.4	12.3	14.2
Exchange Rate (Rupees/USD, p.a.)	0.7	0.8	0.8	1	1.1	1.3	1.9	1.9	1.7	1.8	2	1.9	2	2.1	2.4	2.7	2.8	3.3	3.7
Parallel Market Ex.Rate (Rupees/USD, p.a.)	..	0.8	1	1.1	1.3	2.2	2.6	2.6	2.2	2.1	2.3	1.9	2.4	2.5	2.8	2.9	2.8	3.4	3.7
Money and Quasi-Money (% of GDP)	..	26.5	24.8	24.6	22.8	23.1	23.7	22.5	27	27.7	25.9	25.6	25	27.9	25.2	20.3	20.3	20.1	20.2
Broad Money Growth (annual %)	..	19	-4.4	8.5	28.7	16.6	51.1	8.7	67.2	21.2	46.3	-14	41.6	13.3	-14.4	12.8	12.3	18.8	28.6
Inflation, Consumer Prices (annual %)	..	13.6	16.4	11.1	10.5	8.6	8.1	10	9.8	8.4	11.6	11.4	11.8	16.2	14.3	10.5	10.5	10.1	8.6
Inflation, GDP Deflator (annual %)	1.1	19.1	3.6	-4.3	10.4	8.2	22.7	23.2	6.6	17.2	27.4	6	5.2	5.3	9.1	17	9.3	9.2	15.2
Food Production Index (1989-91=100)	84	73	93	97	90	86	97	95	84	90	93	100	107	103	103	87	104	114	..
Population Growth (annual %)	3.3	3.6	3.6	3.5	3.5	3.5	3.5	3.5	3.4	3.3	3.2	3.1	3	2.8	2.7	2.5	2.4	2.4	2.4
Net ODA, All Donors (bill. USD)	0.01	0.11	0.1	0.1	0.1	0.1	0.1	0.1	0.16	0.15	0.16	0.15	0.14	0.11	0.13	0.09	0.09	0.08	0.12
External Debt, Total (bill. USD)	0.02	0.15	0.17	0.21	0.23	0.27	0.35	0.41	0.55	0.54	0.55	0.56	0.62	0.61	0.66	0.69	0.7	0.61	0.56

Sources: World Development Indicators, World Bank, 1999; International Financial Statistics, IMF, 1998; African Development Indicators, 1998/99 and markets has not guaranteed superior (or even modest) economic performance. Botswana has been noteworthy for its system of governance that values democratic principles, conservative government, fiscal prudence, and monetary discipline. In a word, the GoB has shown restraint. In doing so, Botswana has demonstrated that having abundant natural resources can be consistent with avoiding Dutch disease and with growing rapidly.[39]

Proximity to South Africa: Just as Ireland, Jersey, and the Isle of Mann benefit from being close to but not part of the London financial market, Gaborone offers many advantages to firms whose principals want to be near Johannesburg but not be part of South Africa. As already noted, communications links are excellent, and the connections to other parts of Southern Africa are convenient and regular.

Experience in Asset Management: Institutions within Botswana already have some experience in asset management. This has occurred because of the size of Botswana's official foreign reserves. These reserves, which at times have exceeded the equivalent of three years' import coverage, have provided an opportunity for the private sector to advise the Bank of Botswana on an appropriate (though conservative) investment strategy. Such practices have given firms in Botswana experience in international asset management, creating what has become an embryonic asset management sector.

b. Current Weaknesses of the Financial System in Botswana

There are three aspects of the situation in Botswana that reduce its attractiveness as a financial center. First, South Africa is (slowly) liberalizing its financial sector. Second, many of the potential participants in the proposed financial services center are already established in other countries of Southern Africa. Third, under current circumstances Botswana does not provide any more favored access to South Africa's financial markets than other locations in Southern Africa.

Financial Liberalization in South Africa: Although South Africa still retains a significant number of restrictions, a wide range of controls on financial services have been removed or weakened. Liberalization continues to result in the removal of the most severe restrictions.[40] Were this process to be accelerated now that South Africa has penetrated markets in the European Union, one of the basic presumptions about Botswana's attractiveness to financial enterprises from South Africa would no longer be valid. Botswana would clearly offer tax advantages. Yet, these would be unlikely to compensate for the disadvantages of being away from Johannesburg, of splitting office administration between two centers, of having limited access to skilled financial managers, and so on. Furthermore, even though Botswana's supporters see Gaborone as the platform from which South African enterprises can organize their operations in Southern Africa, the alternative model of "strategic alliances" referred to earlier has advantages as well. South African financial enterprises have been forming alliances with similar organizations in Mauritius and other countries. This approach does not depend on having a particular location as a platform for regional operations.

Whether South Africa will liberalize in ways that undercut Botswana's plans to establish an international financial service center will only emerge over time. Under the SADC protocols, South Africa has been responsible for promoting financial harmonization across the region. Thus far, it has used its position to stall measures that would promote region-wide liberalization and lead to closer financial cooperation among the members of SADC. Botswana will benefit if South Africa continues to delay especially if only a limited number of its financial institutions form "strategic alliances." That is, continued financial rigidities in South Africa may be the boost that Botswana's financial services center needs.

Institutions Already Established in Southern Africa: Yet, there is a further problem. Many financial enterprises based in South Africa already have affiliates throughout Southern Africa. Why would South African financial enterprises that already have broad representation across the region want to consolidate their financial operations in Botswana? Raising this question casts added doubt about the idea that Botswana has specific advantages as a platform for South African enterprises.

Two attractions of any financial center are that they provide access to markets that are otherwise unavailable and they significantly reduce transaction costs. For many of the larger South African enterprises, the relocation of Southern African operations to Gaborone would create redundancy. That would raise rather than reduce costs without improving market access. Furthermore, with the improvements in communications technology, serious questions arise whether a regional coordinating center would even lower transaction costs.

Access to South Africa: Looking to the future, the major attraction for many international financial enterprises of locating in Southern Africa is the potential access it would provide to the market for financial services in South Africa. Its economy is large, dwarfing all its neighbors including Botswana. With appropriate policies, the market for financial services could expand rapidly since its customer base is extensive.

Breaking into that market will not be easy. Thus far, there has been little said by those promoting Botswana as a financial service center of the potential access it provides to South Africa. This is curious because an important opportunity for financial enterprises based in Botswana would be the provision of low-cost statistical services and data processing for South African–based businesses—financial and otherwise. With so much energy devoted to making Botswana attractive for South African enterprises, too little attention has been given to this alternative.

5. The Challenges to Financial Development in Southern Africa

With appropriate policies, Southern Africa has the potential for broad-based financial development in the foreseeable future. This section considers some of the factors that will influence the course of that development.

Limited Economic Reform: Countries such as Mozambique and Tanzania have made substantial progress creating the conditions needed to move beyond the economic disruption of the past. Tanzania is being helped by a natural resource boom (based on small-scale gold mining) that is having a positive impact on employment, real incomes, and the balance of payments. Tanzania has recorded solid growth over the last several years and gives every appearance of continuing.[41] Moreover, Tanzanian policymakers appear to be responding to the new opportunities in ways that maintain macroeconomic balance and foster economic growth. The exchange rate is not being manipulated, the budget deficit is being contained, and efforts to restructure the economy continue.[42] These changes are helping to increase the demand for "traditional" financial services —commercial banking, insurance, leasing, and trade finance. They are also creating a potential demand for some "high-end" asset management, tax sheltering, and investment banking services.[43]

Other countries, particularly Zambia and Zimbabwe, have struggled with different approaches to structural reform. None has succeeded. One imagines (and hopes) that, at some point, the prospect of further economic regression will either force a change in leadership or require the present leaders to take some positive steps to promote reform. Both countries have the rudiments of a sophisticated financial system that could expand rapidly if only income would rise and confidence could be revived. Improvement in these two countries would help change the whole outlook of Southern Africa. So would peace in the Democratic Republic of Congo and in Angola. Since there have been so many false starts in these areas, predictions about when and how such changes might occur have little meaning.

The data in Tables 3, 4, and 5 clearly show that the principal source of macroeconomic instability and a major determinant of the lack of financial development (and indeed financial regression) has been the persistence of budget deficits. Most governments have resisted attempts to reduce these deficits. One problem is that governments mistakenly emphasize the *costs of economic reform*. After years of failure, far more attention should be given to the *costs of not reforming*. Throughout Southern Africa (including South Africa) these latter costs have been huge, reflected in two decades of declining per capita real income, external debt that cannot be serviced without special assistance from the international community, exaggerated rates of inflation and exchange-rate devaluation, currency substitution, and capital flight.[44] Governments committed to reducing these costs would give the highest priority to actions that eliminated their budget deficit.

External Shocks: In the Budget Speech of 1998/99, the minister of finance for Mauritius referred to the difficulties created by the financial turmoil that began to unfold in Asia during 1997 and continued into 1998. His comment is revealing: "The East Asian crisis is a fresh reminder of how, in a short span of time, economic miracles can turn into social nightmares. Its contagion effects have awakened the whole world to the harsh realities of globalization."[45]

While such statements are regularly and widely made, they have become *pro forma*. One can search in vain for signs showing that governments (including the GoM) have taken note of, and responded meaningfully to, the (so-called) "harsh realities." And since the realities are seen as being so harsh, one would expect to find governments devising contingency scenarios that would allow them to respond to the prospect of future financial disruption. Moreover, if the threats were as severe as the above statements imply, one should also expect to find that governments would not hesitate to take measures that generate additional degrees of freedom at the macro level. Such measures would include cutting the budget deficit and adding to foreign reserves. Thus far, however, governments throughout Southern Africa have not responded in this way.[46] They would be well advised to. Financial turmoil will recur. There is little reason to be unprepared.

Access to South Africa's Financial Markets? One of the challenges for Botswana is to use its proximity to South Africa so that financial enterprises based in Gaborone can gain access to the financial markets in South Africa. The focus of developing Botswana as a financial center has placed so much emphasis on encouraging South African–based financial enterprises to use Botswana as a platform, that the issue of the access to South Africa has been glossed over. Whether such access will emerge under the SADC protocols is unclear. As noted earlier, South Africa has managed to avoid opening its markets thus far. Botswana may be more successful gaining concessions on a bilateral basis. The potential rewards for gaining access are relatively large. Many South African financial institutions have been making a special effort to counteract the financial distortions created by apartheid. South Africa has a large segment of its population that is "unbanked," or poorly served by the formal financial system. Since average per capita income is significantly higher than the average incomes in the rest of Southern Africa excluding Botswana and Mauritius, there are considerable incentives for local financial institutions to focus on the domestic market.

Central Bank Operations: As a general rule most central banks in Southern Africa (other than Mauritius and Botswana) perform their functions poorly. Payment systems are inefficient, confidence in the financial system remains low, and financial supervision is weak. It is difficult to explain why. The practice and theory of central banking is well known, and there are many studies of the main principles involved.[47] Moreover, there have been broad-ranging efforts by the largest central banks to improve the coordination necessary to enhance supervision.[48]

Two factors have made it more difficult for central banks in Southern Africa to fulfill their functions. The first is that governments have been unwilling to cut their deficits. As noted earlier, South Africa has run a budget deficit since the late 1960s. Under these circumstances, central bank officials will always be attempting to ward off inflation and balance-of-payments (or exchange-rate) problems. A second problem has been the way that globalization has undercut the influence of the central bank. As noted in Annex B, Gurley and Shaw once argued that the activities of nonbank financial intermediaries would undermine monetary policy and monetary control. After much debate, it was concluded that the effects would not be severe so long as the central bank continued to implement monetary policy and influence the financial system through market mechanisms and not through controls. A similar argument applies to central bank operations in the context of financial liberalization and globalization. Central-bank controls over the financial system have been counterproductive as asset-holders have made alternative arrangements (often offshore). To reestablish their influence, central banks in developing countries have to become fully engaged in working with rather than against trends in the key financial markets. This has proven to be difficult, as many central bank officials prefer the "certainty" of controls. The lesson, however, is that controls created the problems in the first place.

Because so many of the financial difficulties across Southern Africa have been created by irresponsible fiscal policy in the form of persistent government deficits, there has been a strong movement to prevent this form of behavior by making central banks independent. (The details of this strategy are discussed in Annex D.) In practice, there is a major difference between legal independence and operational independence. The latter is far more important than the former. Operational independence typically hinges on a central bank's capacity for sound advice, wise direction, and oversight of the financial system. That, in turn, depends on how willingly the government will exercise self-restraint.

Factors Retarding Growth: Many of the points made above relate to the processes and mechanics of promoting financial services. There is, however, from the start a set of factors that undercut the very elements—rising income and wealth—that stimulate the demand for financial services and that, in turn, sustain the process of financial deepening.

The data reviewed pointed to many of these factors. Rates of saving and investment are generally low. This results in low productivity, which reinforces the low rate of growth. For some countries, the servicing of high levels of external debt imposes such a heavy burden on the budget that it diverts resources away from productive investment. But in other countries where the debt is serviced by foreign aid, the budget allocations are so distorted that public consumption expands at the expense of capital outlays. Furthermore, when the financing for external debt is provided by international agencies, the process of generating and sustaining aid flows diverts official attention from the implementation of policies needed to promote growth.[49]

A further problem retarding growth has been the spread of HIV/AIDS and the generally inadequate response by governments, donors, and employers to counteract the institutional dysfunction associated with the pandemic. Major problems have been the loss of skilled personnel and the behavioral changes of those who have HIV/AIDS. So far, little attention has been paid to the modifications needed in training programs that take into account collapsing earnings horizons among workers. Similarly, there has been little effort to change the goals of key institutions in ways that would focus their agendas and simplify the tasks required of each worker. Finally, too little thought has been given to the problems related to opportunism among workers with HIV/AIDS and the types of incentives that might motivate these workers to avoid such counterproductive behavior.[50]

All of these matters seriously impinge on the process of financial development. Financial institutions require highly skilled workers; financial relationships are developed and maintained on the basis of trust and confidence; and financial stability requires some sense of institutional memory and precedent. All of these have been undermined by the personal and professional changes associated with the spread of HIV/AIDS.

Irreversibility: Attempts to promote financial development need to fully appreciate the limits imposed by irreversibility and option values. Africa has attracted only small amounts of foreign direct investment. So far, private investors have taken little interest in Africa, seeing it as the last option rather than the "last frontier."

The lack of investor interest shows up in several ways. Political risk agencies rank countries in Southern Africa as among the most unstable and least "investor-friendly" locations in the world. Based on the U.S. government's own interagency risk-assessment criteria, few countries in Southern Africa are eligible for official insurance and credit guarantees. In addition, criteria used by the U.S. Export-Import Bank rate most countries in Southern Africa as "unbankable." While the actions of outsiders are relevant, those of locals are more telling. Through capital flight, many investors from Southern Africa have taken advantage of the more lucrative, lower-risk investment opportunities outside of Africa.[51]

The lack of investor enthusiasm for opportunities in Southern Africa is fully consistent with theories of irreversibility and the option value of waiting.[52] When investors are required to make an irreversible commitment to a specific project, there is often little to be lost (with potentially much to be gained) by delaying the investment, especially in the face of uncertainty about future government policy. Investors now have so many alternative investments available worldwide, including the option to hold cash, or "gilts," that they can readily avoid unnecessary risks. Yet for governments in Southern Africa the consequences of delayed investment can be devastating. Tanzania, Zambia, Madagascar, and Malawi have all been bypassed by foreign investors deterred by the uncertainty generated by government actions (as well as inaction, notably the failure to reform).

From their responses, policymakers across Southern Africa have been slow to appreciate the implications of irreversibility and option values. The option of waiting is directly linked to the expectations formed by investors of future returns and the stability of those returns in a particular country. Policymakers who understood this would pay close attention to the impact of their actions on investor expectations. In particular, they would begin to frame their policy actions beginning with the constraints faced by potential investors rather than their own constraints. Were policymakers to think strategically in this way, they would attempt to understand the consequences of their actions and the expectations they generate. A key element in such a strategic approach is to avoid behavior that undermines the confidence of investors and causes them to exercise their option of waiting.

Aid Dependence: For close to four decades, countries across Southern Africa (with the exception of South Africa) have received massive amounts of donor support. (Aid to Botswana and Mauritius began tapering off in the early 1980s when they began to grow rapidly.) The assistance has consisted of balance-of-payments support, debt relief, commodity transfers, and technical (as well as military) aid. The share of aid in GDP has increased sharply in Southern Africa since 1980. Some of the increase has been for humanitarian purposes associated with wars and drought. Some of it has been connected to reconstruction efforts as in the case of Mozambique. Yet whatever the type of aid, the basic intention has been to support adjustment as a means of promoting growth and development. For most countries, growth and development has been elusive even in the face of massive aid flows. One well-known effect is that aid has artificially appreciated the real exchange rate, thereby undermining African competitiveness and preventing the economies from taking full advantage of the expansion of world trade.[53]

More insidiously, the aid has enabled reform to be postponed as governments and donors engage in a variety of "games" related to conditions attached to the aid. These games have seriously distorted the incentives for reform. By supporting governments, foreign assistance has systematically overvalued public sector activities at the expense of the private sector.[54] Despite recent attempts by donors to emphasize privatization and the "nongovernment" sector, this bias has persisted.

Furthermore, foreign assistance has continued flowing to African countries despite their poor economic performance.[55] This has underwritten the accumulation of private wealth even in economies lacking in enterprise and innovation. The only requirement for such accumulation has been individuals (often leaders and their cronies) willing to abuse their public sector positions to divert foreign assistance for their personal gain.[56]

A major element missing from donor programs throughout Southern Africa has been the recognition that the effective use of aid requires governments to act in ways that will allow them to reduce their dependence on aid.[57] A fundamental problem has been the absence of any principle of "self-help."[58] Essential for financial development, this idea provides the foundation for policies designed to mobilize resources domestically rather than to depend on the continued flow of foreign savings.

For African policymakers with the foresight to look "beyond aid dependence" (which also involves looking "beyond the debt overhang"), the challenge is to adopt policies that enable the economy to mobilize adequate resources domestically. One aspect of such an approach would be the formulation of measures that induce local investors to keep their resources "onshore" and use them productively. That would directly reduce dependence on foreign aid and begin to provide a sustainable basis for financing the domestic investment needed to stimulate growth and development.

6. Future Directions: The Role of Botswana and Mauritius in Promoting Financial Development in Southern Africa

If Southern Africa is to grow and develop on a sustained basis, all financial systems within the region will have to systematically deepen. What is not clear at this point is the pattern of financial development that will emerge and the time frame over which it will occur. For their strategies to succeed, the governments of Botswana and Mauritius hope that financial deepening will begin immediately and that it will draw on the type of services—personal and commercial banking, asset management, brokerage, insurance, and statistical services—that are being emphasized in both countries.

While the general direction of financial reform is relatively easy to predict, the timing is a problem. Much will depend on whether the South African economy begins to grow on a sustained basis. Much will also depend on how rapidly other countries in Southern Africa adopt economic reform programs and sustain them. Financial development, to repeat what is now axiomatic, cannot (and will not) occur under conditions of macroeconomic instability, low confidence, and heightened uncertainty. For some countries in Southern Africa, much needs to be done before the basic conditions are in place for financial development to proceed.

Governments that are pursuing economic reform need to resist the temptation to complicate the reform agenda or have it complicated by donor agencies. Only those changes that are essential for adjustment and growth should be emphasized. The most important starting point is government self-restraint. Two elements are critical. First, the operations of government have to cease being a source of macroeconomic disturbance. In this respect, the elimination of the budget deficit should be the highest priority. (This applies to both South Africa and Mauritius.) Second, countries whose governments have become excessively dependent on foreign assistance need to devise and implement a program to work themselves off aid.[59]

These actions—the elimination of the budget deficit and the pursuit of an "aid exit" strategy—would have a major impact on the domestic financial system. Money creation would cease and inflation would fall to levels in line with international rates of inflation. The distortions created by large flows of relatively unproductive aid resources could be slowly removed. Confidence in local financial instruments would begin to revive and local entrepreneurs would have an incentive to begin to take advantage of opportunities for intermediation and productive investment. For some countries, such as Zambia and Zimbabwe, financial reconstruction could occur relatively rapidly so long as asset-holders were confident that the reforms were going to be sustained. For other countries, particularly those facing the task of rebuilding their financial infrastructure (or developing it for the first time), the rebound will be less rapid. Whatever the response, however, further delay in creating the conditions favorable for financial reform cannot help. Indeed, further delay is an implicit decision to allow financial intermediaries based in other countries to continue profiting from local business.

What role might Botswana and Mauritius have in this process? What can their respective governments do? How can their entrepreneurs and financial enterprises respond?

Perhaps the major contribution that both countries can make is to continue performing well so that their financial systems continue to deepen. This will provide an example for other countries in Southern Africa of the potential advantages of financial reform. It will also provide the capacity for strengthening existing links with countries in Southern Africa, such as those that Mauritius has to Madagascar.

The respective governments have a number of options. The governments of Mauritius and Botswana can begin to coordinate their approaches to the promotion of financial services. This seems paradoxical since it appears as though both governments are competing in the area of financial services. However, as described earlier, the approaches taken by Botswana and Mauritius are complementary rather than competitive. Furthermore, experience worldwide shows that financial development involves taking advantage of "niches" and building on them. Botswana is firmly oriented towards financial enterprises from South Africa, whereas Mauritius has been focusing on Madagascar, Mozambique, and other countries on the Indian Ocean rim. Finally, since the economies of scale and scope in the provision of financial services are so extensive, the activities being promoted in both Botswana and Mauritius will prove to be complementary rather than competitive. Individual enterprises may compete but the countries as a whole stand to gain from expansion in their financial sectors.

Accordingly, Botswana and Mauritius have a vested interest in making consistent their financial regulations, supervision standards, and systems of oversight. This is already underway through the adoption of the Basle standards for capital adequacy and supervision. There are, however, other details that could be standardized. If Mauritius and Botswana were to cooperate in this way, their representatives could begin to encourage other countries in Southern Africa to standardize their financial regulations as well. Parenthetically, this was to be done under the

SADC protocols for promoting closer financial cooperation.[60] South Africa assumed this responsibility under the SADC. So far, progress has been slow largely because South Africa has been unwilling to rapidly liberalize its financial system. Thus, official cooperation between Mauritius and Botswana to promote financial development may serve to prod South Africa towards taking the issue of financial reform more seriously.

An obvious, but to date unexploited, link would be for Mauritian entrepreneurs and enterprises to begin tapping Botswana's resources to support investment within Southern Africa. This could be interpreted as another dimension of a "strategic alliance" to promote financial development in Southern Africa. Substantial changes in the pattern of financial intermediation would begin to emerge if long-standing reporting relationships (via London, Paris, or Johannesburg) within major financial entities were modified. Such changes would encourage subsidiaries of leading financial enterprises to begin communicating within Southern Africa itself.

Botswana and Mauritius can also make a contribution to financial development in Southern Africa by encouraging their enterprises and entrepreneurs to seek opportunities throughout the region. One model is the bilateral relationship between Mauritius and Mozambique, which provides an opening for Mauritian businesses to establish an export platform in Mozambique. Together, the governments of Botswana and Mauritius can lobby in various regional forums for other countries in Southern Africa to accelerate their reforms. Trade opportunities and financial links can be publicized. Furthermore, the two governments can urge their counterparts in neighboring countries to abandon the policies leading to stagnation and decline and to adopt policies that, at the very least, provide the prospect of a more expansive future.

What Financial Services? So far in this report, I have examined the circumstances under which Botswana and Mauritius could help stimulate the demand for financial services across Southern Africa. Which services might be relevant? The range is broad—commercial and merchant banking, leasing finance, insurance and reinsurance, trade finance (letters of credit, acceptances, bills of exchange, factoring), correspondent banking, underwriting, syndication, collateralization, credit rating, statistical support, asset management (pension, mutual funds, stocks and shares), security services, private banking, credit card operations, capital services (government and corporate bonds, money markets, and foreign exchange), commodities trading, derivatives, and financial management and advising. The list could be readily extended. Many of these services are already available or through the principals of the financial enterprises (such as banks and insurance companies) in Botswana and Mauritius could be readily available should the demand arise.[61]

It is difficult to determine a priori the types of services that would be demanded of financial institutions located in Mauritius and Botswana. Moreover, it is not clear whether additional research at the macro level would be revealing. The businessmen and women, bankers, officials, and others who provided information for this report were eager to talk in general terms about the emerging areas of opportunity and the willingness of their organization to pursue various strategies to expand the financial services they were offering. Yet all of those interviewed shied away from providing details of their activities.[62]

This does not create difficulties for the present study. The type of financial services demanded and supplied will be determined by the business strategies of the various financial entities whose principals believe Southern Africa has attractive opportunities with risks that are consistent with those their enterprise will bear. Botswana and Mauritius already have sophisticated financial institutions that can cater to local demands should they arise. So far, however, the basic constraint to their expansion has been lack of effective demand. The main services provided to date have responded to various niches. These include retail-banking services in Tanzania, export financing and retail banking in Madagascar, and trade financing and large-scale lending to sugar producers in Mozambique.

The main issue is whether the governments of Botswana and Mauritius, in collaboration with governments in other countries of Southern Africa, can create the macroeconomic conditions that will foster the expansion of income and wealth needed to support the growth of financial services that existing enterprises could supply. This brings us back to the point made earlier: a major requirement for the expansion of financial services is economic growth. For governments anxious to promote financial development in Southern Africa, this may seem to push the problem back one level. Yet when seen in the broader context it should be reassuring. Financial development does not require arcane advances in the theory of finance. It requires a commitment by governments throughout Southern Africa to sustained economic reform. Botswana and Mauritius have already shown the way. The challenge is to encourage other governments to follow their lead.

7. Concluding Comments

This report has discussed the opportunities and constraints associated with the efforts of the governments of Botswana and Mauritius to promote their countries as international financial service centers. During the initial stages at least, Botswana is seeking to provide a low tax platform for financial enterprises in South Africa that need a base for their operations in Southern Africa.

Having been engaged in the provision of international financial services for several years longer than Botswana, Mauritius has broader ambitions. Its goal is to build on the country's substantial investment in information technology and education to take advantage of its location relative to South and Eastern Asia, Europe, and Southern Africa to become a major center for financial intermediation.

Both countries have made a start. Botswana has been working on a comprehensive legislative agenda. Its government continues to manage the economy in ways that will maintain broad macroeconomic stability and support high rates of economic growth. By contrast, Mauritius has been engaged in a process of amending legislation that already supports the expansion of offshore banks, brokerage firms, leasing companies, and other financial enterprises. Through the promotion of information technology, Mauritius has been seeking to ensure that the latest financial innovations are readily available as well.

The most important and potentially sustainable boost for the anticipated emergence of both Botswana and Mauritius as financial centers within Southern Africa will result from the broad-based expansion of real income and accumulation of wealth throughout Southern Africa. This will provide the basis for the sustained expansion in the demand for financial services. Achieving such growth will require all countries to take the steps needed to promote and sustain economic reform. If that reform is to materialize it will have to be based on macroeconomic stability derived from public-sector restraint. A most constructive start would be made if the governments of Zambia, Madagascar, Tanzania, Malawi, and Zimbabwe disavowed deficit financing. (Mozambique is so acutely aid-dependent that it needs a structured program to begin working itself off foreign assistance. For Angola and the Democratic Republic of Congo to develop in any way at all, the civil wars must end.) These changes would sharply reduce inflation and stabilize the exchange rate. They would also begin to help revive confidence and over time provide a basis for the sustained financial deepening.

Under present conditions, none of the countries of Southern Africa will experience immediate or dramatic improvements in either the depth or breadth of their financial systems. Confidence and trust have been fractured on too many occasions for asset-holders to abandon the various parallel financial management strategies they have adopted over time. Besides, the financial services demanded by major enterprises and rich individuals are so readily available abroad and so competitively priced that many of the “local rents” do not outweigh the potential adverse risks involved for asset-holders who move their financial operations “onshore.”

Financial development in Southern Africa is more likely to emerge out of a systematic process whereby countries take the measures needed to reduce their macroeconomic imbalances and raise the incentives for local entrepreneurs and asset-holders to expand productive investment. This implies that financial development will proceed in conjunction with overall growth and development. The challenge for Botswana and Mauritius as they continue to deepen their financial sectors is to help other countries in Southern Africa create similar conditions. That is a challenge that both Botswana and Mauritius are eager to meet. Many potential areas where they might cooperate to do this remain to be explored.

Annex A: Madagascar and the Southern African/Indian Ocean Financial Network

Clive Gray with Pepe Andrianomanana

1. Introduction

The present report was prepared on the basis of consultations in Madagascar during the week of April 18–24, 1999, by the author in conjunction with Professor Pepe Andrianomanana, head of the Centre d'Etudes Economiques (CEE) of the University of Antananarivo, preceded by a week of data gathering by Professor Andrianomanana. The two-person team is referred to herein as the CEE/HIID team. The work in Madagascar was complemented by the author's subsequent consultations in Washington with officials of the World Bank, International Monetary Fund (IMF), and International Finance Corporation (IFC) working on Madagascar.

2. Central Hypothesis of the Study

The Consulting Assistance on Economic Reform (CAER) study on financial development in Southern Africa examines the role, in development of the region's financial sector, of Botswana and Mauritius—the two sub-Saharan African countries that 1) have shown the best long-term economic growth performance, and 2) are explicitly seeking to become regional financial service centers. The study's central hypothesis is that those countries have the potential to provide financial services to the region as a whole, or (in the case of Mauritius) are already providing such services, on a scale far outstripping the role of the Republic of South Africa (RSA). The study takes into account the relative size of the three economies.

3. Mauritian and South African Transactions with Madagascar

Tables A1 and A2 compare economic and financial magnitudes of RSA, Mauritius, and Madagascar on absolute and per capita scales. To begin with, Table A1 shows RSA with 38 times the population, 82 percent of the per capita GDP, and 34 percent of the per capita foreign trade of Mauritius.

Table A1. Comparing Aggregate Parameters of Madagascar, Mauritius, and South Africa

	Madagascar	Mauritius	South Africa
Population (1997, millions)	15.85	1.15	43.34
GDP Per Capita ($, 1997)	224	3,633	2,979
Foreign Trade Per Capita: ($, 1997)			
Imports	49	2,304	827
Exports	68	2,445	793
Total	117	4,749	1,620
1997 Average Exchange Rates Used for GDP and Foreign Trade Conversions	5091/$	20.6/$	4.61/$

Source: *International Financial Statistics,* June 1999, country pages.

Table A2. Monetary Parameters in Madagascar, Mauritius, and South Africa

	1990 Loc. curr.	1990 % of GDP	1990 % of broad money	1997 Loc. curr.	1997 % of GDP	1997 % of broad money
Madagascar						
Money						
End of Period	574			2664		
Begin of Period	598			2168		
Average	586	**12.7%**	**80.5%**	2416	**13.4%**	**71.9%**
Quasi-Money						
End of Period	170			1012		
Begin of Period	114			876		
Average	142	**3.1%**	**19.5%**	944	**5.2%**	**28.1%**
Broad Money—Average	728	**15.8%**	**100.0%**	3360	**18.6%**	**100.0%**
GDP (current prices)	4604			18046		
Velocity	**6.3**			**5.4**		
Mauritius						
Money						
End of Period	5578			10611		
Begin of Period	4511			9830		
Average	5045	**12.8%**	**22.5%**	10221	**11.9%**	**16.2%**
Quasi-Money						
End of Period	18990			57201		
Begin of Period	15765			48407		
Average	17378	**44.2%**	**77.5%**	52804	**61.5%**	**83.8%**
Broad Money—Average	22422	**57.1%**	**100.0%**	63025	**73.4%**	**100.0%**
GDP (current prices)	39275			85892		
Velocity	**1.8**			**1.4**		
South Africa						
Money						
End of Period	50354			173335		
Begin of Period	43343			147664		
Average	46849	**17.0%**	**31.7%**	160500	**27.0%**	**47.0%**
Quasi-Money						
End of Period	105579			195762		
Begin of Period	96625			165626		
Average	101102	**36.6%**	**68.3%**	180694	**30.4%**	**53.0%**
Broad Money—Average	147951	**53.6%**	**100.0%**	341194	**57.4%**	**100.0%**
GDP (current prices)	276060			594858		
Velocity	**1.9**			**1.7**		

Table A2 continued

Comparative %/Ratios

	1990	1997
Mauritius/Madagascar		
Velocity	**27.7%**	**25.4%**
Quasi-Money/GDP	**14.3**	**11.8**
Broad Money/GDP	**3.6**	**3.9**
Mauritius/South Africa		
Velocity	**93.9%**	**78.2%**
Quasi-Money/GDP	**1.2**	**2.0**
Broad Money/GDP	**1.1**	**1.3**

Source: *International Financial Statistics Yearbook—1998*, country pages. Velocity and percentages of GDP are calculated from data in table.

The two categories of data of greatest relevance to this study are 1) comparative financial parameters, and 2) indicators of transactions by RSA and Mauritius with Madagascar.

As one would expect, Table A2 shows Madagascar to be far less monetized than either Mauritius or RSA, with a velocity of 6.3 in 1990 and 5.4 in 1997, against 1990 values of 1.8 and 1.9, and 1997 values of 1.4 and 1.7 for Mauritius and RSA, respectively.[63]

However, the comparison between Mauritius and RSA is the more striking one. From 94 percent of RSA's velocity in 1990, Mauritius increased its monetization faster than RSA, reducing the comparative percentage to 78 percent in 1997. Even more striking is the comparative role of quasi-money in the two economies. Already in 1990 quasi-money accounted for 78 percent of Mauritius' M2; in 1997 the share had risen to 84 percent. In contrast, over the same period the share of quasi-money in RSA declined from 68 percent to 53 percent. In 1990 Mauritius' ratio of quasi-money to GDP was 20 percent higher than RSA's; in 1997 it was 100 percent higher.

As for Madagascar, quasi-money represented only 3.1 percent of GDP in 1990 and 5.2 percent in 1997, in each case less than one-tenth of Mauritius' value.

In a nutshell, Mauritius' extraordinary level of monetization and overall financial deepening represents a platform enabling the country to insert itself in financial systems throughout the Southern African–Indian Ocean region.

As regards macroeconomic indicators of relations with Madagascar, Mauritius is far ahead of RSA on all counts except absolute imports, where RSA, with 6.5 percent of Madagascar's 1998 imports, ranked fourth behind France. (At 26 percent, France held more than three times the share of any other country.[64]) For its part, Mauritius fell in twentieth place, accounting for only 1.2 percent of Madagascar's recorded 1998 imports.[65]

Conversely, on the export front, Mauritius absorbed 7.4 percent of Madagascar's recorded 1998 exports, taking second only to France with 42.3 percent. In this category RSA occupied nineteenth place, taking only 0.8 percent of Madagascar's exports. Moreover Mauritius' share has increased in each of the last two years from a level of 4.9–5.0 perent in 1995–96.

On the services front, the manager of a local consulting company said his firm regularly bids jointly with Mauritian counterparts (including the Mauritian subsidiary of Arthur Anderson) for contracts with major Malagasy enterprises.

Of particular significance is the fact that RSA has no embassy or consulate in Madagascar. An embassy was opened after the fall of apartheid, but closed in 1996. The departing ambassador informed his diplomatic colleagues that his government found too little interest on either side to warrant the expense of maintaining the mission.[66] Knowledgeable Malagasies believe that South African industries are looking towards member countries of the Southern African Development Community (SADC)—Madagascar has not yet joined, although the GoM is considering a formal approach—as loci for investment in labor-intensive industries.

As regards foreign direct investment in Madagascar, Mauritian capital is already present in textiles, printing, computer services, banking, air and sea transport, chemicals, trade and telecommunications.[67] Both the government statistical bureau (Instat) and the central bank (BCRM) research unit informed the CEE/HIID team that they had no country breakdown of foreign investment in Madagascar, either cumulative or in terms of annual flows. France is clearly in first place. Mauritius ranks second to France in the banking sector, and might be second overall, but there is no data to corroborate this.

Project MADIO's 1997 Industrial Survey gives data on Mauritian enterprises enjoying export processing zone (EPZ) status in Madagascar. The number of Mauritian enterprises registered was 23 out of a total of 98 EPZ firms, distributed as follows:

Textiles & leather	9
Services	6
Chemicals	2
Wood, paper, publishing	3
Miscellaneous	3
Total	23

Table A3 gives overall magnitudes for activity of these firms, including their share in Madagascar's EPZ universe. The Mauritian textile and garment firm, Groupe Floréale, described in the Malagasy press as Mauritius' fifth largest company, is the largest EPZ firm in Madagascar. The CEE/HIID team was advised that no South African company enjoys EPZ status.

Table A3. Share of Mauritian Enterprises in Malagasy EPZ Arrangements

	Turnover (bill. Fmg)	Value added (bill. Fmg)	Capital (bill. Fmg)	Employees
Absolute	114.8	23.9	16.1	6,466
% Share	20%	18%	6%	20%

Source: Project MADIO, *Enquête Industrielle—1997*, 1998.

An indicator of Mauritian commercial interest in Madagascar was the fielding in February 1999 of an investment delegation of one hundred participants, led by the economic development minister, which included representatives of seven of the top thirteen Mauritian enterprises.[68] Sectors represented included engineering, hotels & tourism, aviation, soaps & detergents, textiles, poultry, sugar and other agriculture. (A Malagasy with long experience in sugar volunteered to the CEE/HIID team that Mauritius had much to offer that industry in Madagascar, which he described as dilapidated.)

The protocol issued at the end of the mission mentioned agro-industry, EPZs, warehousing, and housing construction as areas of particular interest to Mauritian investors in the short to medium term. Apart from the protocol the two governments signed an agreement on tourism.[69]

The period immediately preceding the present study bore witness to tensions arising from Mauritius Telecom's foray into Madagascar's telecommunications sector. In mid-January 1999, Mauritius Telecom negotiated a partnership agreement with the private Malagasy company Snivi, calling for Mauritius Telecom to invest $15 million in "semifixed" telephones, initially in Antananarivo and subsequently other regions. The Malagasy press condemned the "dilapidation" of the national patrimony, and described the telecom as "the fox of the Indian Ocean."

The GoM viewed the transaction as tantamount to Snivi selling to a foreign company the license it had been granted within the framework of deregulation of the telecoms sector, and cancelled the license within days. Mauritius Telecom thereupon withdrew from the project, citing "differences of opinion with the Malagasy authorities," but indicated its intention to put $4 million into a partnership with the Société Malgache de Mobile, a cellular telephone operator.[70]

France is also a partner in this venture, through the company PROPARCO, supported by the French development aid agency, AFD.

Privatization has been slow in Madagascar—according to the World Bank, the GoM had agreed already in 1987 to privatize the three state banks, yet ten years later two were still in state hands. However, one of these is now controlled by the Société Générale, and the Bank of Africa is expected to take over the third by the end of 1999. No Mauritian institution has participated in these operations (except in the sense that both the foreign banks have minority Mauritian shareholders).

The Ministry for Private Sector Development and Privatization's Privatization Committee listed operations as underway by March 31, 1999, for nineteen state-owned enterprises (SOEs).[71] According to the ministry's secretary general, no Mauritian firm was currently negotiating to take over any of these; however, some "expressions of interest" had been received from Mauritius. Mauritian accounting firms were doing audits of some of the SOEs. A subsidiary of Ernst Young/Mauritius was mentioned in this connection.

4. Madagascar's Financial Sector—A Summary

A 1991 World Bank survey of Madagascar's financial sector, its report published in 1993 under the title "Madagascar—Financial Policies For Diversified Growth," sums up its diagnosis with these words: "As in most low-income countries, Madagascar's financial system is narrow and shallow, comprising a small range of institutions and instruments for mobilizing financial savings and channeling credit."

This diagnosis is still correct, although the intervening decade has seen some progress. Thus, in 1991 the Malagasy commercial banking sector consisted of three essentially bankrupt state-owned banks and one foreign bank, the latter established following a shift in government policy during the 1980s under the pressure of an imploding economy and IMF and World Bank conditionalities.

Eight years later, two of the former state-owned banks had been taken over by multinational bank groups, while privatization of the third was well underway. Of particular significance to this study, two Mauritian banks are now operating in Madagascar, and the Mauritian subsidiary of Barclays is preparing to enter.

Of greatest importance for the progress of Madagascar's financial sector, the rate of inflation is currently under control, having risen from a simple average of 10 percent per annum during 1989–91 to 36 percent in 1994–96 and then fallen to 6 percent in 1998.[72] The administered exchange rate remained virtually constant at around Fmg 1,500/$ during 1989–91. At present, the rate, equivalent to Fmg 5,600/$ in April 1999, is essentially market-determined.

Despite this progress, the demand for cash balances showed only a modest increase through 1997, with velocity averaging 6.1 during 1989–91 and 5.4 during the recent year.[73] The mobilization of saving in Madagascar remains pitifully low. Applying the national accounting identity I-S = M-X to the latest IFS data yields a 1997 saving rate of 3.3 percent.[74]

The cost of financial intermediation, measured by banks' gross earnings margin, has remained excessive, approximating 1.5 percent of GDP in 1997. However, this was a decline from 2.0 percent in 1996, and it is expected that, once the remaining state bank is privatized and Barclays has initiated operations, increasing competition will further narrow the spread between lending and deposit rates.

As of mid-1999, the insurance sector comprises two state-owned companies. Government has agreed to privatize both during the year, and a legal code establishing the preconditions for a private insurance industry has just been approved by the National Assembly.

According to the IMF and World Bank, the biggest obstacle to expanding financial services in Madagascar is weak enforcement of contracts. In principle the law allows banks to foreclose on collateral, but judges are biased in favor of borrowers. Banks find themselves the object of harassment suits when they try to collect. This phenomenon also affects the prospects of developing a leasing subsector, for which only skeletal legislation exists. Malagasy law prohibits foreigners from owning real estate, but World Bank has raised the possibility of introducing *liens* ("bail emphythéotique") as an alternative.

Another major shortcoming lies in the area of accounting and auditing. The local oligopoly resists entry, not only of multinational firms qualified to apply international standards, but even of Malagasy personnel trained abroad. Present conditions are not compatible with the standards of financial disclosure required to develop a securities market.

Madagascar does not have a stock exchange, although senior officials are attracted by the idea of establishing one.[75] Some foreign observers favor diverting this interest into fulfilling the preconditions for a securities market, which could be gradually developed through a network of brokers well in advance of establishing a stock exchange as a distinct institution. More than one of the CEE/HIID team's local informants suggested as a first step listing some Malagasy companies on the Mauritius exchange. They cited as a model the recent listing of several South African companies on the London exchange.

5. Mauritian and South African Financial Initiatives in Madagascar

In 1994 the Mauritius Commercial Bank established a Madagascar subsidiary—Union Commercial de Banque, or UCB—while the island's largest bank, State Bank of Mauritius (SBM), entered in early 1998. Bank market shares are not publicly reported, but sources in the banking community informed the CEE/HIID team that UCB currently accounts for 6 to 7 percent of total commercial bank assets, while SBM's share is around 3 percent. SBM indicated that it was operating profitably within a year after establishment.

Such figures are quite respectable, considering the two banks' recent establishment and the fact that each has only one branch at the moment, both in Antananarivo (UCB informed us of plans to open one in Tamatave and an additional branch in Antananarivo). We were also informed that the two banks' market share is rising steadily. Local observers advised us that this reflects a high degree of confidence in Mauritius on the part of Malagasy customers, as well as an expectation (perhaps already experience) of superior service. One informant stated that the influential Indian business community in Madagascar is particularly attracted to the SBM.

With each of the two banks, the Mauritian institution is the technical partner and majority shareholder. BCM holds 70 percent of UCB's shares, with RSA's Stanbic Bank holding 10 percent and the local venture capital firm FIARO holding 5 percent. SBM's share in its subsidiary is 55 percent, while Nedcor Bank Ltd. (Nedbank) holds 30 percent. In 1997 the International Finance Corporation (IFC) agreed to take 15 percent of SBM shares and provide a credit line of up to $5 million; however, SBM eventually rejected IFC involvement on the ground, so we were advised by bank staff that IFC's insistence on an option to withdraw after five years was too constraining.[76]

The CEE/HIID team was advised that the two South African banks are happy to use their roles in the respective Mauritian subsidiaries to watch the Madagascar scene, but are unlikely to play a more active role in the foreseeable future.

UCB and SBM officials indicated that, while their initial client bases in Madagascar had comprised Mauritian companies with subsidiaries or branches in the country, restricting themselves to Mauritian clients would not have allowed them to satisfy regulatory requirements for loan portfolio diversification.[77] Thus, Mauritian enterprises now accounted for well below half of their business (although an outside informant claimed that UCB specializes in two categories of customers—firms trading with Mauritius, and EPZ firms). Both banks said they aim to provide a full range of services within the local banking sector and to increase their market shares by attracting additional Malagasy as well as other foreign customers.

Local sources pointed out that the synergy between Mauritian banks and investors runs in both directions. In other words, while Mauritian manufacturers were first *in situ*, the presence of UCB and SBM reassures late-coming industries.

SBM struck the CEE/HIID team as the more dynamic of the two Mauritian banks. It alone has an automatic teller machine. The manager (a Mauritian) said his bank sees Madagascar becoming a dynamic, open economy in another ten to fifteen years and wants to get in on the ground floor. He listed his bank's aspirations:

- As early as possible, SBM/Madagascar plans to open an asset management subsidiary targeting exporters' foreign exchange balances.

- The bank intends to be listed on the Madagascar stock exchange once that is established.

- The bank will establish a leasing subsidiary once an adequate legislative framework exists, giving a foreign-controlled institution (or a domestic one, for that matter) effective authority to realize collateral.

- The bank believes substantial opportunities for agro-industrial investment exist in Madagascar. The manager mentioned sugar, maize, chicken feed, poultry, and dairy. However, the Malagasies are ambivalent about foreign investment in the sector. The February delegation discussed a possible 30,000 ha. project (Plaine de Samangoky) and signed a protocol, although no operational agreement is yet in sight.

- On the deposit side, SBM is targeting the flight capital that has left Madagascar, which the manager estimates at anywhere between $200 million and $500 million. The bank believes it can assure owners' safety and satisfactory returns.

No Mauritian venture capital firms are yet established in Madagascar. The manager of the sole domestic company, FIARO, indicated that at least one Mauritian counterpart had contacted FIARO, but preferred to participate in specific projects with Mauritian investors rather than establish a subsidiary in Madagascar. The Mauritius Commercial Bank has a 1.3 percent share in FIARO itself.[78]

A local insurance executive told the CEE/HIID team that at least two Mauritian insurance companies were exploring the possibility of entering Madagascar once the new insurance code (before the National Assembly in May 1999) is adopted. The probable mode of intervention for the Mauritians would be a minority share in multinational groups expected to bid for the two state companies (Ny Aro and Ny Havana) scheduled for privatization in the second half of 1999. Only one foreign company, the Aga Khan's Nairobi-based Jubilee Insurance, has indicated firm plans to set up independently.

6. Conclusion

Clearly Mauritius is already providing financial services in Madagascar way out of proportion to its geographical and economic size, and is poised to play an increasing role, augmenting its substantial lead over its South African counterparts, which remain content with a watching brief. On the other hand some observers advised the CEE/HIID mission that the weight of opinion in the Mauritian business community finds Madagascar a frustrating place, still ambivalent towards private enterprise and foreign investment. The view was expressed more than once that many Mauritian entrepreneurs view Mozambique as a more dynamic host for investment and financial services.

Annex B: Financial Deepening and Investment in Africa: Evidence from Botswana and Mauritius

Malcolm McPherson and Tzvetana Rakovski

1. Introduction

This annex examines the hypothesis, proposed by Ronald McKinnon, that in a fragmented financial system money and investment are complementary. We test the hypothesis using data from Botswana and Mauritius. Our intention is to better understand the factors associated with financial development in Southern Africa so that policymakers can devise more appropriate strategies to achieve sustained economic growth.

Over the last three decades, both Botswana and Mauritius have grown rapidly at the same time as their financial systems have expanded and deepened. Their experience provides an opportunity to examine some aspects of financial development in Southern Africa and how financial systems might be transformed in ways that support rapid economic growth.

The essay is arranged as follows. Section 2 reviews theoretical developments and practical experience against which McKinnon formulated his hypothesis. Section 3 reports the empirical results and assesses their significance. Section 4 concludes with a discussion of the policy implications of the results.

2. Historical Background

It is now more than twenty-five years since Ronald McKinnon published *Money and Capital in Economic Development.*[79] McKinnon along with Edward Shaw[80] fundamentally changed the way that development economists thought about the contributions of money and finance to economic development. Earlier work by Raymond Goldsmith had identified the key processes involved in financial development and the conditions under which financial systems systematically "deepen" over time.[81] Goldsmith showed that as income rises and economic activity expands, financial intermediation leads to the progressive "layering" of financial assets and liabilities. The intermediation is due to an expansion of traditional banking services and the increasing role of nonbank financial intermediaries (NBFI).

Gurley and Shaw had earlier noted the growing importance of these intermediaries when they argued that their activities posed potentially serious problems for monetary management and monetary policy.[82] Subsequent analysis led to two conclusions.[83] First, monetary management would not be undermined if the monetary authorities exerted control over the financial system by operating through the financial markets.[84] Second, the growing role of NBFIs was stimulated in part by the opportunities for intermediation created by monetary policy measures that restricted the operations of banks—at that time the dominant financial entities.

The implication was that financial development (or financial "deepening") responded to rising income and wealth and attempts to control the activities of financial intermediaries. Income and wealth stimulate the demand for financial services. Controls and restrictions on financial intermediaries create the incentives for further financial intermediation by generating "quasi-rents" that reflect differences in information and risk among participants in financial and capital markets.

A well-known historical example is the development of the Euro-dollar market.[85] This market was stimulated by several developments. Due to their rising income and broader participation in world trade, a number of countries (particularly the Soviet Union and other Eastern European countries) began accumulating large U.S. dollar balances. Because of the Cold War, these countries were unwilling to hold dollar deposits in the United States. Banks in London began offering dollar-denominated deposits that they then loaned to customers who found it convenient to borrow dollars outside the United States. The market was given a boost during the 1960s by restrictions imposed in the United States to reduce the balance-of-payments deficit. The United States was unwilling to devalue the dollar at the time because such action would have risked destabilizing the international financial system. The various controls—the interest equalization tax in 1963, restrictions on foreign borrowing in the United States in 1965 and attempts to force U.S. corporations to borrow abroad in 1968—were costly for both Americans and foreigners.[86] These measures encouraged those who required U.S. dollars to seek accommodation in countries unhindered by U.S. controls. With more dollars being held outside the United States and rising demand to avoid the various restrictions, many opportunities for intermediation emerged.

In contrast to this experience where controls on money and finance created opportunities for financial intermediation, evidence from developing countries was showing that controls and restrictions often resulted in financial disintermediation. An obvious case was Latin America, where financial development had stalled. Indeed, capital flight had become a problem. In Asia, controls on financial intermediaries were creating a number of problems, giving a boost to informal markets and exacerbating inflation.[87]

This was the intellectual and practical background against which McKinnon and Shaw framed their analyses of the problems of promoting financial development. Both of them clearly recognized that increasing income and wealth expanded the demand for money and financial assets. They also understood that official controls could create the opportunities and incentives for financial intermediation. What their analyses (and those of other scholars) were showing, however, was that controls and restrictions could be overdone. When markets are dynamic and robust, controls generate opportunities for financial intermediation. But in economies lacking dynamism, controls can intensify the fragmentation of financial (and other) markets and discourage financial intermediation.

Accordingly, McKinnon and Shaw turned their attention to explanations of how government interference could block financial development. A major problem was the excessive use by governments of "captive markets." These are financial intermediaries, such as banks, insurance companies, and pension funds, that are required to accommodate government borrowing irrespective of the costs involved. The adverse effects were compounded when governments placed limits on interest rates that could be paid on deposits or charged on loans, and fixed a rate of exchange for the national currency. Almost invariably these financial prices were inconsistent with the particular country's capacity to export, import, and attract foreign investment. The outcome was a set of policy-determined distortions in the financial system. These eroded the incentive for further financial development leaving the financial system "shallow" and less dynamic than it might otherwise have become.[88]

Both McKinnon and Shaw sought approaches to the management of money and credit that would help reduce the degree of fragmentation in financial markets. For McKinnon, financial market fragmentation and the limited opportunities for intermediation in developing countries were symptomatic of the broader problem of economic underdevelopment. He noted "[t]he economy is "fragmented" in the sense that firms and households are so isolated that they face different effective prices for land, labor, capital, and produced commodities, and do not have access to the same technologies."[89]

But fragmentation was not only a consequence of the lack of economic development. McKinnon's point was that it could be accentuated by inappropriate public policy. He stated:

> Fragmentation in the capital market—endemic in the underdeveloped environment without carefully considered public policy—causes the misuse of labor and land, suppresses entrepreneurial development, and condemns important sectors of the economy to inferior technologies. Thus, appropriate policy in the domestic capital market is the key to general liberalization, and particularly to the withdrawal of unwise public intervention from commodity markets.[90]

Having made the connection between intervention and fragmentation on the one hand and capital accumulation and economic growth on the other, McKinnon asserted that removing distortions from the capital markets was essential to the promotion of broad-based financial and economic development. He concluded that "unification of the capital market, which sharply increases rates of return to domestic savers by widening exploitable investment opportunities, is essential for eliminating other forms of fragmentation."[91]

This conclusion has been confirmed in many subsequent analyses.[92] The practical implication, examined empirically below, is that in a fragmented economy, money and physical capital (and investment, which adds to that capital) are complements. McKinnon was explicit:

> The demand for real money balances will be strongly influenced by the propensity to save (invest). More precisely, *if the desired rate of capital accumulation (and hence private saving) increases at any given level of income, the average ratio of real cash balances to income will also increase.* (Italics in original).[93]

Thus, in an economy that is undergoing financial development, we should expect to find a strong positive association between investment (and savings) and money demand. Only when an economy reaches a stage of advanced financial maturity with low degrees of fragmentation in capital and goods markets should we expect the positive association between investment and money demand to weaken and even reverse (as implied by neoclassical portfolio theory).

3. Empirical Analysis and Results

This section reports empirical tests of McKinnon's hypothesis using both single and simultaneous equation techniques. The single equation estimates provide a direct test of degree to which money demand and investment are complementary. The simultaneous equation estimates indicate the strength of that relationship while taking into account the dependence among the money, investment, and other macroeconomic variables.

The data for Mauritius cover the period 1967 to 1997. For Botswana, they relate to the period 1971 to 1997. Unless we note otherwise, the source is the country data set in the "International Financial Statistics," June 1999 (CD-ROM data set) from the International Monetary Fund.

a. Single Equation Estimates

We specify the following relation:

$$(1) \qquad \mathbf{(M/P)^D = f\,[y, I/Y, \pi^e\,]}$$

where **y** is the real income, **I/Y** is the ratio of investment to GDP and π^e stands for expected inflation. Apart from one detail, this is the same relation proposed by McKinnon. The difference is that McKinnon included the real rate of interest. We have included expected inflation as an analogous indicator of the opportunity cost of holding real money balances. Following a simple version of adaptive expectations we approximate π^e with the rate of inflation from the previous period.

All variables are in logarithms. The growth rates are calculated as first differences in logs of the respective variable. Expected inflation is the first difference of the price level in logs lagged by one period. Standard errors are shown in parentheses. Two asterisks indicate statistical significance at the 5 percent level. One asterisk denotes significance at the 10 percent level. All real variables are deflated using the consumer price index of the respective country.[94]

The estimated real money demand function for Mauritius is:

$$\mathbf{\ln(M/P) = -\,3.87 \;+\; 1.32\,\ln y \;+\; 0.31\,(I/Y) \;-\; 0.61\,\Delta \ln P[-1]}$$
$$\qquad\qquad (0.50)^{**} \qquad (0.06)^{**} \qquad (0.52) \qquad (0.36)^{*}$$
$$R^2 = 0.97 \quad DW = 0.65$$

The estimated coefficients of real income and the investment/GDP ratio have the expected positive sign. Only the former is statistically significant. The demand for real money balances is negatively and significantly related to expected inflation. This is consistent with the theory. Expected adverse changes in the price level reduce the demand for real money balances.

To deal with collinearity between real income and the investment/GDP ratio we dropped **lny** from the equation. This change accentuates the effect of the investment/GDP ratio but at the expense of a much lower r-squared and more severe autocorrelation.[95]

$$\mathbf{\ln(M/P) = 7.76 + 7.50\,(I/Y) - 2.45\,\Delta \ln P[-1]}$$
$$\qquad (0.51)^{**} \quad (2.00)^{**} \qquad (1.66)$$
$$R^2 = 0.35 \quad DW = 0.31$$

This result supports the null hypothesis that, in Mauritius, real money demand and investment have been complementary.

For Botswana, the estimated money demand equation is:

$$\mathbf{\ln(M/P) = -0.04 + 0.90\,\ln y - 2.44\,(I/Y) + 2.57\,\Delta \ln P[-1]}$$
$$\qquad (1.02) \quad (0.10)^{**} \quad (0.83)^{**} \qquad (1.83)$$
$$R^2 = 0.93 \quad DW = 1.39$$

Real money demand is positively and significantly related to real income. The sign on the coefficient on the investment/GDP ratio is highly statistically significant and negative. This is contrary to McKinnon's hypothesis.

A possible explanation for this result is that the majority of Botswana's investment has been undertaken by the mining sector and the government, neither of which have been resource-constrained as a result of limited financial development. In this respect, Botswana has been atypical of developing countries with its pattern of investment deviating from "normal" (in the Chenery-Syrquin sense) trends. During the initial expansion of the mining sector, investment rates were inordinately high.[96] They have since tapered off as the mining sector has reached sustainable levels of production and the public sector has caught up the backlog of infrastructure and other development expenditure.

These results indicated that we should explore the relationship between real money demand and domestic savings in Botswana.[97] Including the savings/GDP ratio in the real money demand function gives:

$$\mathbf{\ln(M/P) = -2.54 + 1.07\,\ln y + 0.46\,(S/Y) + 4.23\,\Delta \ln P[-1]}$$
$$\qquad (0.66)^{**} \quad (0.11)^{**} \quad (0.88) \qquad (2.68)$$
$$R^2 = 0.90 \quad DW = 0.95$$

While the coefficient on the savings ratio is not statistically significant, the positive sign hints that in Botswana there has been some complementarity between savings and real money demand.[98] As above, dropping **lny** from the relation yields:

$$\mathbf{\ln(M/P) = \underset{(0.96)^{**}}{2.45} + \underset{(1.59)^{**}}{5.89}\,(S/Y) + \underset{(5.18)^{**}}{18.66}\,\Delta \ln P[-1]}$$

$R^2 = 0.46$ DW = 0.93

Allowing for the collinearity reveals a highly significant association between real money demand and real savings. This is consistent with McKinnon's hypothesis.

b. Simultaneous Equations Estimates

The simultaneous equations system consists of three equations in three endogenous variables: the growth rates of real money demand, real income, and real investment. Our intention was to capture the spirit of McKinnon's hypothesis in a simultaneous equation context so that the direct and indirect effects among the variables (including feedback) are taken into account. To better reflect the dynamic nature of financial development, we specified the relationships in terms of growth rates. We estimated the system using 3SLS. We tested different specifications of the equations for each country and experimented with several lag structures and instrumental variables. The results proved to be robust and theoretically plausible.

Table B1 reports the results for Mauritius.[99]

Table B1. **Mauritius**

	Dependent Variables				
	Δlnm		Δlny		Δln(inv)
Δlny	0.74 (0.20)**	Δln(inv)	0.29 (0.06)**	Δlne	0.74 (0.32)**
Δln(inv)[-1]	0.17 (0.07)**	Δln(inv)[-1]	0.05 (0.06)	Δlnm[-1]	0.94 (0.38)**
		Δln(ex)	0.20 (0.10)*		
Constant	0.03 (0.02)	Constant	0.02 (0.02)	Constant	-0.02 (0.05)

Relative to the single equation estimates, the system estimates point to a complex pattern of mutual dependence among real money demand, investment, and income. The effect of the income growth and the lagged investment growth on the growth of real money demand is positive and statistically significant. The growth of real income, not surprisingly, is strongly related to investment growth and the growth of exports. The investment growth equation confirms that real exchange rate depreciation improved the balance of payments and raised the rate of investment. Feedback from money to investment is captured in the coefficient on the lagged value of the growth of real money balances. This variable is positively and significantly related to the growth of investment.

Table B.2 has system estimates for Botswana.

Table B2. **Botswana**

	Dependent Variables				
	$\Delta \ln m$		$\Delta \ln y$		$\Delta \ln(inv)$
$\Delta \ln y$	2.05 (0.50)**	$\Delta \ln(inv)$	0.12 (0.08)	$\Delta \ln m$	0.41 (0.19)**
$\Delta \ln(inv)[-1]$	-0.56 (0.21)**			$\Delta \ln e[-1]$	-0.78 (0.33)**
		$\Delta \ln(ex)$	0.30 (0.08)**		
Constant	-0.03 (0.06)	Constant	0.05 (0.02)**	Constant	0.03 (0.05)

The two sets of results have many similarities. This reflects their shared history of sustained, export-driven growth and development. The results show that there has been positive mutual dependence between the growth of real investment and the growth of real money demand. The growth of real exports is positively and significantly related to the growth of real income. For reasons given earlier, the growth of real income has not been significantly related to the growth of real investment. Once underway, income growth has been sustained by investment derived from high rates of profit in the mining sector and taxes on those profits.[100]

4. Concluding Comments

The results presented here provide some empirical details of the trends associated with financial development in two of Southern Africa's most successful economies. Considered broadly, the results support McKinnon's hypothesis. There has been some complementarity between investment/savings and real money demand. Both Botswana and Mauritius have moved from a situation characterized by a high degree of market fragmentation to one where their officials see them becoming important international financial services centers. Throughout this process, both economies have experienced significant financial deepening, more so in Mauritius than in Botswana. In both countries, financial deepening has involved simultaneous increases in savings, investment, real income, and real money demand.

The empirical results also point to some of the factors supporting these changes. Two are noteworthy: the high income elasticity of demand for money and the positive impact of changes in the real exchange rate, particularly in Mauritius. The consistently high values for the income elasticity of demand for money (the coefficients on **lny** in the money demand regressions) point to a broad pattern of macroeconomic management that has maintained macroeconomic stability and fostered the demand for money and, by extension, a broader range of financial assets.[101]

The impact of the real exchange rate reflects a pattern of exchange rate management together with the associated policies related to trade, debt, and foreign aid, that has maintained external balance in both countries. Indeed, Botswana has experienced a major sustained increase in foreign exchange reserves.

These results provide useful lessons for other countries in Southern Africa. From Botswana, we learn that it is possible to be richly endowed with natural resources and grow rapidly based on responsible fiscal and monetary management. From Mauritius, we learn that it possible to be poorly endowed with resources, be geographically isolated, and yet still grow rapidly as well. The factor common to both countries has been that their governments have fostered the conditions needed to exploit comparative advantages of each country. Vital dimensions of those conditions were the self-restraint by government needed to prudently manage the economic surpluses and the commitment to macroeconomic stability required to stimulate and sustain financial deepening of the type that would enhance economic growth.

Annex C: Finance Capital and Real Resources

Malcolm McPherson

A common presumption in many of the countries of Southern Africa has been that financial capital (i.e., money and credit) will create real capital. This is a serious, widespread, and continuing lapse in economic logic that has been common to both developing countries and economies in transition. It has led to the general overexpansion in money and credit, producing high inflation, devaluation, capital flight, and financial disintermediation. Indeed, *if* finance had been a source of real capital, most of the countries of Southern Africa (particularly Tanzania, Zambia, and Zaire), which have had extraordinarily high rates of credit expansion over the last three decades, would now be exceedingly wealthy countries.[102]

The conditions under which finance can "create" real capital—stable prices, adequate foreign exchange reserves, excess productive capacity, and no adverse effects of the credit expansion on expectations[103]—are stringent. They have rarely been satisfied anywhere in Africa over the last three decades.[104]

Finance can only increase real capital if it mobilizes (i.e., frees up) real savings, that is, real resources that have been explicitly set aside from current income flows for purposes other than consumption. The following quote makes the point:

> Although the existence of a more developed capital market and financial intermediaries will aid in the collection and distribution of investible funds, they in no way lessen the need for real saving. The rate of investment which it is physically possible to carry out is limited by saving, and a "shortage of capital"—in the sense of a shortage of real resources available for investment purposes—cannot be solved merely by increasing the supply of finance. [105]

The basic task of any financial system is to transfer resources from those who are willing to and capable of lending to those who are willing to and capable of borrowing. By accepting financial liabilities (i.e., providing credit), individual lenders release their surplus resources (i.e., their savings) to other individuals and firms who promise to discharge the liabilities from the financial surpluses that they anticipate generating from their investments.[106]

By aggregating all borrowers and lenders in the economy (or, more generally, all savers and investors), the familiar national accounting identities emerge: [107]

(1) $Y = C + S$

(2) $Y = C + I + X - M$,

where Y is gross domestic product
- C is aggregate consumption (private and public)
- S is gross domestic savings
- I is gross domestic investment (including inventories)
- X is exports of goods and nonfactor services
- M is imports of goods and nonfactor services.

Equating (1) and (2) and rearranging gives

(3) $S - I = X - M$.

Any difference between real domestic investment and real domestic saving is balanced by the difference between imports and exports.

Identity (3) can be satisfied in a number of ways. Consider, for example, some of the possible adjustments when government expenditure increases without any change in tax rates.

- Private investments are crowded out through higher interest rates or credit rationing.

- If there are idle resources (including ample foreign exchange reserves), the increased demand will raise real output yielding higher tax revenues and increased private saving.

- If there are no idle resources and monetary policy does not limit the growth of demand, prices will rise and government spending will be covered by forced saving (through the "inflation tax").

- The increased domestic demand may be matched by higher imports. That may occur through exchange rate depreciation. Imports might also be covered by capital inflow from foreign aid, government borrowing abroad, or private flows in response to higher interest rates.

In the countries of Southern Africa there are seldom sufficient idle resources (apart from unskilled labor) to permit a substantial "Keynesian" output response to higher government spending. Increased government spending is often directly linked to increased foreign assistance or deficit financing. Private resources are limited, especially when low confidence among investors leads them to shift or keep their resources abroad. Exchange depreciation has its own costs in terms of inflation and the redistribution of wealth. The "forced saving" solution is costly, counterproductive, and ultimately leads to a net loss of resources, especially in highly indebted countries.[108] Finally, changes in interest rates are typically too small relative to other risks to attract capital inflow.

Countries wishing to raise real output on a sustained basis have to mobilize additional resources.[109] This process requires a stable financial setting in which the individuals and firms who generate surpluses will transfer them to those in the domestic economy who have the capacity to create additional output. By contrast, the explicit use of financial instruments to extract these surpluses (via inflation, low interest rates, or controls designed to generate "rents" that can be "captured") is counterproductive. It eventually produces lower saving and investment and slower growth or, as in several countries of Southern Africa, economic contraction.

Gaining access to foreign savings (through external borrowing) does not solve the problem either. Indeed, the problem is compounded when those foreign savings are used inefficiently.

Annex D: Central Bank Independence as a Factor in Financial Development[110]

Malcolm McPherson

Central bank actions directly affect the cost and availability of credit, and indirectly affect output, employment, price level, the exchange rate, and the balance of payments. These actions have an impact on the welfare of almost everyone, often with significant political repercussions. For their part, governments frequently adopt policies that are financially disruptive. They require banks to lend at below-market interest rates to designated sectors. They also spend more than can be adequately funded by tax receipts and by borrowing from the domestic nonbank public. Moreover, governments are often slow to reverse counterproductive policies such as food subsidies, tax holidays, and chronically overvalued exchange rates.

These conflicting pressures generate friction between the central bank and the government. Supporters of one side can always find fault with the other. Politicians deflect blame if they can. Central bank officials suggest that their policies would improve if only the government would not interfere. Many observers believe that the solution is to make the central bank "independent" of government.

1. Government and the Financial System

A common feature of African countries is that governments intervene in the financial system. Sometimes the intervention is *ad hoc* in response to pressing policy concerns, such as the imposition of interest rate ceilings to reduce the cost of borrowing for particular groups. Often, however, it results from a conscious effort to "promote" economic development.

Experience of the last three decades, especially in Southern Africa, provides useful lessons about the government's role in promoting financial development. First, bureaucrats (whether party appointees, central bank officials, or senior staff members of the ministry of finance) have made poor commercial and/or development bankers. Second, politicians typically fail to distinguish between real and financial resources, leading them to encourage the overexpansion of finance and credit. Third, delaying action does not deal effectively with an economy's financial problems. Fourth, the financial system is an inefficient means of redistributing wealth. And fifth, efforts to promote financial reform by re-engaging the private sector do not succeed until entrepreneurs are convinced the government will not re-intervene.

Governments have typically appointed civil servants or political supporters to manage state-owned financial organizations. This has been a costly mistake. Few have proven to be competent managers, let alone skilled bankers. The financial and economic costs have been high.

As discussed in Annex C, few politicians understand the difference between real capital and financial capital. The former can be transformed into the latter whenever there is a market; the latter can only be transformed into the former when there is additional real savings.

Politicians have been also been poorly advised regarding the type of policies needed for financial stability. Fixed interest rates and exchange rates provide stability in two nominal parameters but usually at the expense of instability in variables such as monetary growth and external debt. The franc zone countries had a fixed exchange rate from 1948 to 1994. This did not prevent each of the countries from experiencing major fluctuations in their real exchange rates, accumulating large amounts of foreign debt, and regressing economically.[111]

The postponement of financial reform in the hope that the situation will correct itself has been common throughout Southern Africa. This reflects a general lack of appreciation by policymakers of the speed of adjustment in financial markets.[112] Failure to deal with financial problems generates distortions elsewhere in the economy and undermines confidence. Furthermore, postponing financial reform typically increases the cost of restructuring.

Using the financial system to redistribute wealth in ways that enhance development has a poor record in Southern Africa (and elsewhere in the developing world). For example, the common justification for "cheap" credit is that the members of the particular group the government wants to subsidize is "too poor" to pay high rates of interest.[113] Such programs are inefficient (i.e., they waste resources), ineffective (i.e., they do not reach the target group), and inequitable (i.e., they worsen the distribution of income and wealth). The lesson is that the financial system is not the mechanism by which specific activities should be subsidized (through "cheap" loans) or for making grants to favored groups (through the noncollection of loans). If governments wish to support specific groups or activities while creating conditions conducive to financial development, a more satisfactory, transparent, and ultimately cheaper solution is a budget subsidy.

Finally, there is widespread evidence that government interference directly discourages private participation in the financial system. Few private entrepreneurs have been willing to invest in financial institutions while governments continue to place arbitrary restrictions on financial markets. Indeed, the broad pattern of financial disintermediation that has occurred across Africa is evidence that when given the chance most firms and individuals withdraw their capital from the sector.

2. The Effectiveness of Central Bank Action

While government interference raises a number of questions, there has also been considerable debate about the impact on the economy of central bank actions. The role of central banks has emerged over a long period of time. Many central bank functions have been the result of pressures and controversies. Historically, the first central banks were founded to finance the government. Over time, concern shifted to arrangements for meeting the "needs of trade" while minimizing the danger of inflation fueled by excessive currency issue.[114] At other times, central banks have been concerned with maintaining currency convertibility, and stabilizing prices and exchange rates. These tasks have typically involved compromises that left no one satisfied. The central bank would be criticized for being too restrictive and too dedicated to inflation control, or for giving way to political pressures and accommodating government deficits or other inflationary pressures.

Over recent years, there have been two sets of criticisms. Some observers want to integrate central bank actions with the government's macroeconomic policy and make the bank accountable to the legislature. Others argue that central banks have allowed other macroeconomic policy concerns to undermine their obligation to maintain a stable currency.

In practice, there is a wide range of arrangements. At one extreme are the central banks that are part of the government and merely carry out government policy. At the other extreme are central banks whose governors and managing boards act autonomously, serve long terms, and cannot be removed readily.

Formal arrangements, however, are not the whole story. The ability of the central bank to pursue any policy ultimately depends on public support for the bank. This in turn is related to its reputation for competence and good judgement as an institution. If the bank lacks strong public support, the government can always change the legislation governing the central bank.[115] The Bundesbank in Germany is famous for its independence of the government, but that independence rests on the strength of popular support for its anti-inflation policy. The Federal Reserve System in the United States is, as Robert Roosa noted, "independent within but not of the government."

Form versus Substance: The formal relations between the central bank and the government are important primarily because they influence the difficulty faced by any government that seeks to override the policy of the central bank.[116]

In practice, the independence of a central bank is a matter of degree—of how far the bank can go in raising interest rates or restricting the growth of money and credit. It is also a matter of how long restraint can be maintained, how often it can be applied, and how often it can be reapplied (if need be). The degrees of freedom enjoyed by the bank at any one time depend in part on the powers granted to it by legislation and by the security of tenure of its management. Its freedom to act also relies upon the base of political support for the bank as an institution. That support will depend in part on the bank's reputation for competence and objectivity. The leeway available to a central bank at any time hinges on the political balance between those who benefit and those who bear the costs of any change in policy. This has been most evident in the focus on "inflation" as a major—and for some countries *the*—monetary policy goal. As in times when "monetarism" held sway and central banks were judged by the degree to which they controlled the growth of the money supply, central bank performance is now being judged by the success in controlling inflation. The operational model of "inflation targeting" has attracted widespread attention.[117]

Responses to central bank policy are not symmetrical. There is much more popular complaint about restrictive actions than about expansive ones. Whatever the long-term consequences the immediate effects of expansive actions usually benefit far more people than they hurt.[118]

Testing the Limits of Independence: As a general rule the independence of a central bank is most likely to be tested when its pursuit of policy objectives conflicts with the economic objectives of the government. More specifically, conflict may arise when the bank's objectives for price and exchange rate stability require credit restraint because of

- increasing budget deficits,
- reduced export earnings,
- a decline in official transfers, or
- inflationary pressures from rising import prices and poor food crops.

Central bank mangers may believe that increasing nominal demand associated with higher government spending will start a spiral of rising prices, and wages and exchange rate depreciation that will be difficult to reverse. If the bank maintains a monetary program consistent with price stability, the government will find that it must either accept the interest rate increases that crowd out private expenditure or give up its effort to increase expenditure.

When faced with supply side pressures on prices, central bank managers may also believe that early and vigorous action will keep in check price increases before a wage-price spiral gets underway.[119] They may also see such actions as helping maintain confidence in the country's commitment to a stable exchange rate. Nevertheless, credit restraint—whether through rising interest rates or rationing—is always painful. In the last three cases above, a period of reduction in domestic consumption and investment accompanied by high unemployment is to be expected if the central bank's objectives for price stability are to be achieved.[120]

If the central bank were to pursue its objectives without regard to their political implications, the government may be forced to use (or threaten to use) any policy levers available. It could, for example, inform the governor of the central bank and board members that their reappointment would be contingent on a change of policy. It could instigate legislative hearings on the central bank's policies or arrange for legislation to change the central bank's charter. The outcome of those maneuvers would depend on the strength of public support for the bank as an institution relative to support for the policy objectives of the government.

The government will find that open conflict with the central bank also has political consequences. The central bank will have to compromise, however, if it has little support as an institution and finds the public unwilling to bear the costs of reducing inflation. In fact, central bank managers typically consider the political implications of their proposed policies. They tend to proceed gradually and limit their restrictive actions when there is too much opposition. They may attempt to reach a compromise over policy before acting.

Indeed, in most cases, that happens when substantial conflict exists between the policy that a central bank would pursue if it were left to itself, and the one desired by the government. The United States Federal Reserve is generally regarded as one of the most independent central banks in the world yet it has often compromised to avoid an all-out conflict with the president and with Congress. Moreover, while the Bundesbank, also regarded as highly independent, does not often conflict with the government, it has always enjoyed strong popular support.[121]

Legislation ensuring long terms for governors and directors, and providing budgetary autonomy for the central bank, strengthens the hand of the bank in reaching a compromise. Moreover, it helps the bank operate independently when it needs to make gradual changes in interest rates. The government may also tolerate actions by the central bank that it would never take itself. It seems unlikely, for instance, that any American government would have undertaken the policy pursued by the Federal Reserve from 1979 to 1982. Yet two administrations watched those actions without attempting to interfere. Nevertheless, the Federal Reserve cannot take those kinds of action (raising interest rates, restricting monetary growth, and creating widespread recession) very often. Political tolerance for restrictive policy is limited.

There is, therefore, benefit to government of modifying legislation in ways that improves the central bank's negotiating position. The size of the benefit will depend on the basic political situation. In countries where there is no large and influential financial community and where one party regularly controls the legislature, a central bank is unlikely to achieve any substantial independence on the basis of its legal position. The government will usually manage to keep the bank in line when it wishes to do so. In those circumstances the central bank's management will be more effective by working from within the councils of government than by attempting to assert its independence.

3. Inflation Contracts, Currency Boards, and Dollarization

Faced with persistent inflation, several governments have made legislative changes which sought to "tie their hands" by effectively tying the hands of the central bank. Perhaps the most dramatic change was made in New Zealand where the Reserve Bank was given one objective—low inflation—and the governor's tenure was made dependent upon keeping inflation below a specified rate. Initially, this "experiment" in inflation fighting was a major success. Under the influence of diminishing budget deficits and broad-based deregulation and privatization, the New Zealand economy performed well for a number of years.[122] Inflation fell to very low levels. Yet in recent years, there have been problems as the economy experiences deflationary pressures. The appropriate fiscal stimulus is precluded by the tight monetary policy the governor of the Reserve Bank is obliged to implement to meet his "contract."

A further change has been the revival of currency boards. Argentina is the most famous example although several of the Newly Independent States (notably Latvia and Estonia) also established currency boards.[123] The general idea, to paraphrase Peter Kenen, is to impose a mechanism so that the balance of payments determines the local money supply and not vice-versa.[124]

With its history of rapid monetary growth, budget deficits, chronic external debt problems, and (sometimes) hyperinflation, Argentina was (perhaps) an "ideal" candidate for the introduction of some rigid scheme, which forced the government to exercise self-restraint. The problem, however, is that the currency board arrangement has now locked Argentina into an increasingly unrealistic exchange rate. That rate can be changed by abandoning the currency board arrangement, but only at an immense cost to confidence and loss of reputation. Nonetheless, the devaluation of Brazil's currency in early 1999 has placed severe pressure on Argentina. In order to remain competitive, it has to undergo severe deflation (shades of the 1930s). To ameliorate the difficulties, the Argentine government announced in July 1999 that it was imposing tariffs on imports from other countries in MERCOSUR (the Southern Common Market). Since this grouping is committed to free trade, this is a retrograde step. The logical solution would be for Argentina to devalue. The basic lesson from both New Zealand and Argentina is that, in a dynamic world, mechanisms for "tying the government's hands" are useful but they can be overdone.

A third possibility is "dollarization" through the adoption of some other country's currency.[125] This does not eliminate the need for a central monetary authority. The financial system still needs supervision, the government requires banking services, and payment mechanisms potentially require lender-of-last-resort facilities. However, dollarization rules out the adoption of an independent monetary policy and severely limits government scope for discretionary action with respect to fiscal policy and public debt management.

4. Overview

The debate over whether central banks should be independent (in one or more of several senses) will continue. All arrangements have their merits and demerits. History has shown (and continues to show) that the basic issue is not whether the central bank is independent, or whether there is a currency board, or whether the economy is dollarized. The key issue is the behavior of government. Any government exercising fiscal self-restraint will not generate the conditions—chronic deficits, high inflation, exaggerated levels of debt—that typically undermine the central bank's ability to stabilize the economy. Those who advocate "greater" independence of central banks as the means of holding governments accountable or reducing the threat posed by "runaway" government spending have mistakenly placed their faith in the wrong institutional arrangement. A central bank "independent" of government is an arrangement that only the government can initiate and sustain. This means that the arrangement can be reversed should the government so chose.

The key to persistently low inflation is government restraint, not central bank independence. For, if the central bank begins to behave in ways that the government finds unduly restrictive, its charter will be changed. The ideal situation, however, would be restraint on the part of both organizations as they jointly determine and implement a longer-term strategy for promoting rapid growth and development. Such an approach would allow independent action for both the government and the central bank within a coherent and consistent macroeconomic framework.

Endnotes

[1] SADC evolved from the former grouping SADCC (Southern Africa Development Cooperation Council), which was the group of "front-line" states formed to oppose apartheid in South Africa. Democracy in South Africa undermined the rationale for SADCC.

[2] Some examples include: Duesenberry 1965; Goldsmith 1969; McKinnon 1973; Shaw 1973; Cole and Patrick 1984; Fry 1988; von Pischke, Adams, and Donald 1983; World Bank 1989; von Pischke 1991; Cole and Duesenberry 1992; White 1993; Senbet 1996; Harwood and Smith 1997; Mehran et al. 1998, and *Economist,* January and September 1999.

[3] The governor of the Reserve Bank, Dr. Christian Stals, visited the Harvard Institute for International Development (HIID) in May 1997 and delivered a paper on South Africa's role in promoting financial development in Southern Africa. He admitted that such a program would make sense. His paper, however, was largely a restatement of the principles of prudent financial management combined with the reassertion that South Africa must be wary of taking steps that threaten its balance of payments and internal financial stability (Stals 1997). The essence of this message is repeated in the South African Reserve Bank Annual Report of 15 August 1998 (available on www.resbank.co.za). The recent appointment of Mr. T. T. Mboweni to succeed Dr. Stals as governor is unlikely to lead to significant shift in Reserve Bank policy especially on issues affecting countries outside South Africa.

[4] The recently concluded agreement between South Africa and the European Union which results in substantial liberalization of trade between them stands in direct contrast to the overall lack of progress that countries in SADC have made in gaining access to South Africa's markets (Associated Press, 25 March 1999). Despite protocols that call for major rationalization of the systems of trade, exchange, and finance throughout SADC, there has been limited movement. The major stumbling block has been South Africa's unwillingness to dismantle key elements of the trade and financial protection held over from the predemocracy era.

[5] South Africa's major banks have been making a concerted effort to show that they are sensitive to the problems of poverty, inequality, and lack of access. A scheme by Stanbic Bank to provide banking services in low income areas, dubbed e-banking, has met with some success. Recent studies supported by USAID under EAGER/Public Strategies for Growth with Equity project and conducted by a team directed by Don Mead of Michigan State University have highlighted the credit constraints facing small and medium enterprises. The World Bank has also been focusing on spreading formal banking services to the "unbanked" (Paulson and McAndrews n.d.; World Bank 1999). The implication is that South Africa has much to do domestically without concerning itself with financial development outside its borders.

[6] Senior government officials in South Africa continue to be openly critical of protectionism in large-country markets although South Africa maintains steep levels of protection, particularly against products whose export from other members of SADC would provide a major boost to output and employment. Remarks by Trevor Manuel, minister of finance of South Africa, to the World Economic Forum in Windhoek 16–19 May 1998.

[7] IMF Staff Country Report No. 98/96, September 1998. The pattern of financial intervention in South Africa continues to be extensive. It can be readily explored on the Reserve Bank's Web site (given above in note 3). For example, Appendix 11 lists the Acts, some dating from 1943, that remain under the purview of the bank's policy board. Exchange controls remain in effect and according to Stals (1998), their removal would only be "gradually" completed over the next five years.

[8] Zimbabwe is experiencing serious inflation after incurring large budget deficits (*Economist* July 1998). Zambia has recently failed to meet the performance criteria of its second Enhanced Structural Adjustment Program with the IMF. This is the second time since 1995 that a three-year ESAF has failed at the start.

[9] *African Development Indicators,* 1999.

[10] That string of surpluses was recently broken in 1998 with a budget deficit of around 7.5 percent of GDP. The authorities in Botswana have taken several measures in the most recent budget (Government of Botswana, February 1999) to eliminate the deficit (BIDPA 1999).

[11] Fry 1988; von Pischke 1991; White 1993; Mehran et al. 1998.

[12] Under EAGER/Public Strategies for Growth with Equity, several teams of researchers are examining the conditions for "Restarting and Sustaining Growth and Development in Africa" (Duesenberry, Goldsmith, and McPherson 1999).

[13] This may be verified from country data in various editions of the IMF's *International Financial Statistics Yearbook*.

[14] IMF 1996b, 1998; Mehran et al. 1998; Bradley 1999.

[15] Offshore banks were not required to meet statutory reserve provisions. Initially at least, they could not lend to Mauritian-based organizations and they had to conduct their transactions entirely in foreign exchange. The Bank of Mauritius was not obliged to provide them with accommodation (IMF 1996b).

[16] There is an excellent summary of the major changes made to the financial system from 1966–67 to the present in the Bank of Mauritius' *Annual Report 1997–98*, 1998, pp. 9–17.

[17] Regulators are well aware that financial innovation proceeds partly in response to the restrictions that limit bank operations. They are also aware that one of the reasons for revising regulations is to "catch up" with financial innovations (Haubrach 1996; Cecchetti 1998, 1999; Hoenig 1997; Huh 1997; Berger, Demsetz, and Strahan 1998; Federal Reserve Bank of New York 1998; Fischer 1999).

[18] Ref: http://neb.intnet.mu.medre.vision.html p. 7 (of 11).

[19] IMF 1996b:39.

[20] These banks are in addition to the ten commercial banks and nonbank financial institutions such as the Stock Exchange of Mauritius, the Post Office Savings Bank, the Mauritius Leasing Company, the State Investment Corporation, the National Mutual Fund, the National Investment Trust, the National Pension Fund, the Sugar Insurance Fund Board, and the Mauritius Housing Company Ltd. (BoM *Annual Report 1997–98*, 1998, pp. 55–56).

[21] Bank of Mauritius *Annual Report 1997–98*, October 1998, pp. 93–94.

[22] IMF 1996b: 41–42.

[23] During the 1990s, the money/GDP ratio in Mauritius has been higher than in the United States. Between 1992 and 1998, the ratio of broad money to GDP in the United States varied between 0.58 and 0.63. (*International Financial Statistics,* September 1999).

[24] IMF 1996b, Appendix II, Table I, p. 86; IMF 1998b, Table 2, p. 5.

[25] World Bank 1997a.

[26] In discussions with me, a senior BoM official noted: "financial deregulation does not mean no guidelines." One set of guidelines has been a banking code of conduct (BoM 1998). The intention has been to ensure that banks in Mauritius provide all customers with high-quality service.

[27]BIS 1988; BoM "Annual Report 1997–98," 1998, pp. 86–92. In the light of the recent modifications to the Basle Accords, which place greater responsibility for prudent financial behavior on the banks themselves, one can expect the BoM to begin (cautiously) changing its procedures. The proposed revisions place more emphasis on the internal

risk-management models being used by the financial enterprises themselves (McDonough 1999). This trend, noted in the text, has been forced on financial supervisors by the growing sophistication of asset- and risk-management models (Simons 1996; Hendricks and Hirtle 1997; Maxfield 1997; Mayer 1997; FRBNY 1998; Chancellor 1999; Teitmeyer 1999).

[28] BIS 1997.

[29] The budget deficits have had other adverse effects. Over the 1993–1998 period, money supply in Mauritius increased by 86 percent, central government debt rose by 108 percent, and the price level increased by 52 percent. Such a high rate of inflation relative to Mauritius' trading partners significantly appreciated the real exchange rate over the 1993–1996 period. The situation has eased somewhat over the last two years (see Figure 1). The real exchange rate has depreciated due mainly to the sharp nominal depreciation of the rupee relative to the U.S. dollar. From December 1996 to February 1999, the rupee depreciated by 23.4 percent.

[30] The GoM has taken note of the problems created by the lack of coordination. The recent budget speech announced the formation of a high-level technical coordinating committee that will meet weekly to ensure that all relevant officials remain abreast of developments in monetary, fiscal, debt, and exchange rate issues (Pinan 1999).

[31] The approach is described in the BoM *Annual Report 1998–99* (p. 51).

[32] The same point is made with respect to the U.S. (Berger, Demsetz and Strahan 1998:34).

[33] Government of Botswana Task Force, Sept. (Gaolathe 1997:76).

[34] Republic of Botswana *Budget Speech 1999*, 8 February 1999, paragraphs 44 and 45.

[35] Government of Ireland 1998.

[36] These are being coordinated in a project of the Botswana Development Corporation. See "Botswana IFSC Projec," 1999 (Botswana Development Corporation).

[37] "Botswana IFSC Project," 1999, p. 4.

[38] The legislation provides a start. Since the GoB has no intention of encouraging "brass plate" operations, some yet-to-be-determined investment in infrastructure will be required. A major effort will be needed in staff training, especially if Botswana is to raise its standards to levels suited to international financial operations (BIOB 1998).

[39] Roemer 1982; Hill and Mokgethi 1989; Barclay 1997.

[40] IMF 1998 (study of South Africa).

[41] Over the period 1994–95 to 1998–99, real GDP growth has averaged 4 percent per annum. Exports have increased, and the government budget deficit has been cut sharply. Further data may be found on the Web at www.imf.org, press release no. 99/6, 8 February, 1999.

[42] The recent speech by President Mkapa at the John F. Kennedy School of Government at Harvard University (Mkapa 1999) portrayed Tanzania as a vibrant country that is committed to democracy and good governance, and except for a heavy external-debt burden, it is on the move. This contrasts with other evidence, however. Bloom and Sachs (1998) report that a Taiwanese firm that had attempted to set up operations in Dar es Salaam withdrew because of aggravation, inefficiency, and delays in moving goods into and out of the country.

[43] The demand for these services is likely to remain limited. The very wealthy are already being accommodated by financial enterprises outside Africa. Whatever inconvenience this may impose is readily offset by the advantages of the safety and anonymity provided by "offshore" accounts.

[44] Ajayi 1997; Calamitsis et al*.* 1999; Stein 1999.

[45] Republic of Mauritius 1998b.

[46] This is a curious phenomenon. The literature on the Asian crisis and others that preceded it continues to expand. A basic theme that is directly relevant to countries in Southern Africa is the importance of promoting financial stability. Some examples include: Goldstein and Turner 1996; Guitian 1998; Marshall 1998; Mathieson, Richards, and Sharma 1998; Perkins 1998; Rose 1998; Rodrik 1998; Knight 1999; Chang 1999; Harris 1999; and Moreno 1999.

[47] Jucker-Fleetwood 1964; Furness 1975; Newlyn 1977; Kitchen 1986; Goodhart 1988.

[48] Areas of international cooperation in supervision and surveillance are examined in Teitmeyer 1999.

[49] Alesina and Weder (1999) test whether "corrupt governments receive less foreign aid." Based on a rich, diverse data set, their analyses indicate that the donors have not discriminated against corrupt governments. This is a depressing conclusion.

[50] There are many examples. Donor projects experience higher rates of pilferage and outright theft. The perpetrators know that punishment they receive (if any) can only be a relatively minor inconvenience relative to the fact that with HIV/AIDS they have a truncated life span. Theft has thus become a means of gaining access to an advanced death benefit.

[51] This point was made in the context of foreign direct investment above. It is a recurring theme in discussions of Africa (cf. *Financial Times*, 21 March, 1999: 34–37).

[52] Pindyck 1991; Hubbard 1994; Severn 1996; Cuddington, Liang, and Lu 1996. The discussion by Keynes 1936 (Preface, Chapter 12) of "expectations" emphasizes the value of liquidity when conditions are uncertain. "Going liquid" is a common way of keeping options open.

[53] Recent econometric evidence derived from small-scale simultaneous equations models of separate African countries (Kenya, Zambia, and Ethiopia) shows a complicated set of relations among foreign aid, the growth of real GDP, government revenue, imports, and the exchange rate. These results show that the impact of aid has ranged from insignificant to mildly adverse (McPherson and Rakovski 1998a,b; 1999).

[54] Friedman (1958) argued that foreign aid favors public sector activity at the expense of private activity. As such, it directly undercuts private sector activities that are the principal source of sustained growth and development.

[55] Johnson 1997; World Bank 1998c.

[56] Sandbrook 1986, 1987; Parfitt and Riley 1989; Ayittey 1992, 1998.

[57] In principle, this is precisely what the stand-by loans and structural adjustment facilities provided by the IMF are meant to achieve. In practice, the IMF has typically been co-opted. The problem is that the IMF has become the "development" organization (dispensing concessional resources) that its founders did not want it to become.

[58] USDS 1964; Bell 1965; Orme 1995. At one time, this idea was a principal motivation for, and requirement of, foreign aid, especially from the United States. It was progressively dropped as aid agencies competed for influence and jostled to promote their own agendas (one of which has been to prolong their own activities).

[59] HIID 1997; McPherson 1999a.

[60] Hawkins 1993; SADC 1999.

[61] Examples of the services provided by the principal financial enterprises are readily available from their literature. Barclay's Bank, for example, which is represented in both Mauritius and Botswana, has detailed material on its activities (Barclays 1998). It also provides useful summaries of local economic conditions and opportunities for business and commerce (Barclays 1997). It should be emphasized that the theory and practice of finance have been shifting (Cochrane 1999, 1999a). This suggests that any newly established organization should be flexibly structured so as to respond to changing market trends.

[62] During my interviews with managing directors and financial controllers of the various organizations that have contributed information to this study, I indicated that I was seeking information on the opportunities for the expansion of financial services, the major constraints facing financial enterprises as they attempted to expand internationally, and expected areas of opportunity. One managing director of a large bank in Botswana, with its headquarters in South Africa, noted that bank strategy is determined in Johannesburg and not in Gaborone. In Mauritius, the managing director of a foreign-owned bank noted that corporate strategy was determined in London. No doubt it would be possible to derive what past strategies have been from a review of the historical record. Nonetheless, the proprietary nature of the material related to market development and potential new client bases suggests that attempts to learn about the plans of the existing financial entities would be extremely difficult without highly detailed case studies. This accounts for the focus of this report on the broader macroeconomic conditions needed to foster financial development rather than the specific activities (current and anticipated) of individual financial enterprises.

[63] We define velocity as GDP divided by M2 (= money + quasi-money).

[64] We exclude from trade rankings recorded imports from and exports to Madagascar's own industrial export processing zones.

[65] All trade data here are taken from computer files supplied by Instat.

[66] Information provided by the World Bank resident representative in Antananarivo.

[67] *L'Express*, 20 February, 1999.

[68] *L'Express,* 20 February, 1999, p. 5. Size based on 1997 turnover.

[69] *L'Express*, 25 February, 1999.

[70] *L'Express*, 3 February 1999.

[71] Source: April 1999 issue of the monthly newsletter "Madagascar Privatisation," published by the Privatization Committee under the Ministry for Private Sector Development and Privatization.

[72] From IFS consumer price series, percent change over preceding year.

[73] The 1989/91 figure is calculated from IFS data by dividing the sum of GDP for 1989–91 by the summed averages of beginning- and end-of-year M2 figures for those three years.

[74] According to IFS (figures in billion Fmg), gross fixed capital formation was 2,140, imports of goods & services 5,477, and exports 3,937. This yields gross saving of 600, equivalent to 3.3 percent of GDP at market prices = 18,051.

[75] Cf. article "Malagasy Stock Exchange, Bientôt une Réalité" (". . .Soon a Reality"), *Madagascar Privatisation*, April 1999. The article depicts the budding stock exchange as a necessary vehicle for participation of the Malagasy public in the ongoing privatization campaign.

[76] Curiously, the project still had a page on the IFC's Web site as of late-April 1999.

[77] Malagasy banks are restricted to lending no more than 40 percent of capital to a single borrower.

[78] Source: FIARO brochure as of April 1999.

[79] McKinnon 1973.

[80] Shaw 1973.

[81] Goldsmith 1969.

[82] Gurley and Shaw 1955, 1956, 1957, 1960.

[83] Johnson 1962.

[84] This has been reinforced by changes in central bank behavior—particularly its shift from direct controls over money and credit to the more extensive use of indirect controls. For sub-Saharan Africa, this topic was examined in Duesenberry and McPherson (1991).

[85] McKinnon 1979: Ch. 11; Kindleberger 1987; Calvo and Reinhart 1999.

[86] McKinnon 1979: 259–261.

[87] Relevant literature includes Bottomley 1964; de Oliviera Campos 1964; Patrick 1966; Johnson 1967:67-78; Adams 1971; and Friedman 1973. A major conference was sponsored by USAID summarizing the experience with credit programs in Latin America and Asia. These studies provide numerous examples of the negative effects of controls on financial development (cf. Donald 1976).

[88] Gillis, Perkins, Roemer and Snodgrass 1996: Ch. 14, especially pp. 376–380.

[89] McKinnon 1973: 5.

[90] McKinnon 1973: 8.

[91] McKinnon 1973: 9.

[92] Some of which include Cole and Park 1983; von Pischke, Adams, and Donald 1983; Fry 1988; World Bank 1989; von Pischke 1991; White 1993; and Mehran et al. 1998. An appreciation of the intellectual history of McKinnon's contribution to the field of financial development can be gained by comparing the attention the topic received in Meier's editions of *Leading Issues in Economic Development.* In the 1970 edition, financial development has three entries (pp. 210–229). By contrast, the sixth edition in 1995 devotes close to a chapter to the issue.

[93] McKinnon 1973: 57.

[94] Preliminary analysis of the stationarity of real money, real income, savings and investment for both countries using augmented Dickey-Fuller unit root test and Phillips-Perron unit root test indicates that all the variables are I(1) in levels and I(0) in growth rates.

[95] This strong positive effect of the investment/GDP ratio remains when the lagged value of real income is used in the real money demand function instead of the contemporaneous value:

$$\mathbf{\ln(M/P) = \underset{(0.57)^{**}}{-3.06} + \underset{(0.06)^{**}}{1.23} \ln y[-1] + \underset{(0.60)^{**}}{1.20} (I/Y) - \underset{(0.42)^{**}}{1.29} \Delta\ln P[-1]}$$

$R^2 = 0.96$ DW = 0.82

[96] During the 1970s the average investment share in Botswana was 39.9 percent. In the 1990–1997 period, the average investment share was 28.3 percent.

[97] Recall the quote from McKinnon above: "The demand for real money balances will be strongly influenced by the propensity to **save** (**invest**)." (Emphasis added).

[98] One explanation for the positive coefficient on the expected inflation term for Botswana is that Botswana's price history is largely a function of what happens in South Africa. As a member of the Southern African Customs Union, Botswana is directly linked to the South African economy. As shown in McPherson (1999), South Africa has had a long history of elevated inflation due largely to chronic budget deficits. This has led to "imported inflation" in Botswana.

[99] Lowercase letters denote variables in real terms. Only growth rates of the variables have been used in the system. Instruments are all the exogenous variables (real export growth, real exchange rate depreciation) and their lags, the lags of the three endogenous variables, and contemporaneous and lagged values of real interest rates, budget deficit, external debt, and foreign aid growth. Exports are measured in U.S. dollars. The exchange rate is measured in end-of-period units of domestic currency per U.S. dollar. Real exchange rate is defined as the nominal exchange rate times the ratio of the U.S. WPI and domestic CPI. The source for exports, external debt. and foreign aid is *World Development Indicators*, 1999, World Bank.

[100] We also estimated the relationship between the growth of real money demand, real *savings*, and real income for Botswana using 3SLS. Table B3 has the results.

Table B3. **Botswana**

	Dependent Variables				
	Δlnm		Δlny		Δln(sav)
Δln(sav)	0.34 (0.21)*	Δln(sav)[-1]	0.10 (0.06)*	Δlnm[-1]	-0.21 (0.14)
Δlne[-1]	0.60 (0.39)			Δlny	2.16 (0.38)**
		Δln(ex)	0.29 (0.08)**		
Constant	0.09 (0.05)	Constant	0.04 (0.02)**	Constant	-0.08 (0.05)

The growth of savings has a positive effect on the growth of real money demand and on real income growth. Both coefficient estimates are significant at 10 percent. Not surprisingly, the association between money demand and savings is significantly different from that of money demand and investment.

[101] See McPherson (1999) and the sources cited there.

[102] For example, in Zambia from 1970 to 1994, the kwacha value of domestic credit increased by a factor of 1147 (i.e., approximately 115,000 percent). The outcome was not economic growth and development but economic decline and financial regression.

[103] Potentially adverse expectations effects were central to Keynes' *General Theory* (1936). He observed that "A monetary economy, we shall find, is one in which changing expectations about the future can influence the current rate of employment and not merely its direction. . ." (vii).

[104] Botswana and Mauritius are the only exceptions. Both countries have achieved high rates of capital formation through policies that encourage high rates of real savings and investment. This has occurred against a background of monetary and financial stability.

[105] Meier 1989: 178.

[106] Meier 1989: 178–182.

[107] Helmers in Appendix B of Dornbusch and Helmers (1988) casts the following relationships in terms of gross national income, gross national savings, and the current account of the balance of payments. The difference arises because gross national income (which is equivalent to consumption plus gross national savings) equals gross domestic product minus net factor payments abroad plus net unrequited transfers received. The essential point of these relationships, however, is that any gap between savings and investment is offset (*ex poste*) by corresponding adjustments flows to and from the rest of the world.

[108] McPherson (1999) shows that the inflation tax (a component of seignorage) has some major offsetting costs, especially in countries with large external debts. In particular, these countries lose seignorage through the feedback from inflation to the exchange rate effects on the domestic currency cost of external debt service (including capital losses in domestic currency terms).

[109] They also have to use their existing resources more efficiently. There are overlapping effects here. Policies that mobilize resources also tend to provide incentives for the resources to be used efficiently.

[110] This section revises and updates material in Chapter 10 in Duesenberry and McPherson (1992).

[111] Devarajan and de Melo 1987, 1991; Gray and Duesenberry, Ch. 6 in Duesenberry et al. 1996.

[112] It might be argued that in light of the financial crises in Mexico (1994), Thailand, Indonesia, Korea (1997), Russia (1998), and Brazil (1999) policymakers are more aware of the dangers of financial disruption. But as noted in the text, while their statements acknowledge the risks, their risky behavior continues—especially the unwillingness to cut budget deficits.

[113] Adams 1977; Gillis et al. 1996: Ch. 14.

[114] Goodhart 1988.

[115] Such a situation arose in Canada when the government and the governor of the Bank of Canada could not agree.

[116] Central bank independence has been widely discussed. Some sources include Fair 1979; Goodhart 1988, 1994; Greenspan 1996; and Maxfield 1997.

[117] Mishken and Posen 1997; Fischer 1997; Huh 1997; Bernanke and Mishken 1997; McCallum 1997; Spiegel 1997; Masson, Savastano, and Sharma 1998; Mishken 1999; and Bernanke, Laubach, and Mishken 1999

[118] Only economists and some financial groups seem to complain that expansionary central bank policies may lead to inflation.

[119] For example, in the United States the explicit policy of the Federal Reserve Bank since 1996 (particularly since Chairman Greenspan's "irrational exuberance" speech) has been directed towards preemptive changes in interest rates so as to reduce the prospects of having inflationary pressures take hold. This interpretation of the Fed's stance (and the wisdom of its execution) has been regularly challenged by the *Economist* (cf. 25 September 1999: 17–18).

[120] There are (by now) many explanations for persistent high unemployment in Europe—close to 10 percent on average for a decade and a half (IMF 1999). One precursor was restrictive monetary policy. In view of the widespread official concern over low inflation and a strong mark/euro, this policy stance has been maintained.

[121] The Bundesbank, however, did not prevail in its dispute with the government over the rate of conversion of the ostmark for the deutschemark during the reunification of Germany.

[122] Evans et al.1996; Walsh 1996; Pou 1997.

[123] Hanke and Schuler 1994.

[124] Central Bank of The Gambia 1978.

[125] Calvo and Reinhart 1999.

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